1919
Federal Income
and
War Tax Laws

HALSEY, STUART & CO.
INCORPORATED--SUCCESSORS TO
N. W. HALSEY & CO., CHICAGO

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Hillison & Etten Company
Printers and Binders
Chicago

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THE WAR TAX LAW.

1. The Revenue Act of 1918, enacted in February, 1919, collects and codifies, with important additions and amendments, all the federal legislation providing for special war taxes and for the taxation of incomes and profits. The law deals with several distinct subjects of taxation, each of which is discussed in a separate title in this book. It is properly styled the War Tax Law, because of the very high rates of tax imposed and the wide field of subjects covered, both these features being directly due to the extraordinary need for revenue resulting from the war. The end of the war, however, does not bring, even remotely, the end of the taxes imposed by the present law, although undoubtedly many special fields will be abandoned and many rates will be from time to time materially reduced. Certainly income taxes, and probably excess profits taxes, will continue to be an established part of the fiscal system of the federal government and the rates can not be expected to return to the prewar standards.

2. **Previous Legislation.** The War Taxes are in many respects similar to those imposed in Civil War times and again resorted to because of emergency in 1898 and 1914. Income taxes were levied at the time of the Civil War but the present system really began in 1909, with the tax on corporation incomes which was designed to supplement the reduced tariff. In 1913, after the adoption of the Sixteenth Amendment removing certain constitutional restrictions upon income taxation, a general law was adopted taxing individuals as well as corporations. This was revised and extended by the Revenue Law of 1916, and again by the Revenue Law of 1917, which introduced the Excess Profits Tax. Stamp taxes, special occupation taxes, excise taxes, and the capital stock tax, were adopted in 1914, 1916, and 1917, along lines used in previous laws. All these taxes, and the new War Profits Tax, are reenacted by the 1918 law, with increases in rates and with many additional features. The present law has therefore many of the features developed under the old laws and will be governed in its interpretation and administration by the Regulations of the Treasury Department and the judicial decisions under the former laws, upon which this volume is based.

3. **Rulings of the Treasury Department.** The administration of the Revenue Law is in the hands of the Treasury Department and the Bureau of Internal Revenue. The Secretary of the Treasury and the Commissioner of Internal Revenue are expressly authorized to make rules and regulations to carry out the provisions of the law and collect the tax. These rulings are promulgated either as decisions of particular questions or instructions on particular subjects, known as Treasury Decisions, or as numbered Regulations which cover an entire branch of the law and provide general instructions for its administration. These may be secured from local collectors. In addition, instructions to collectors and revenue agents are issued in other forms and letters of advice are addressed to taxpayers, many of these being made public through unofficial channels. The law also creates an Advisory Board to assist in the interpretation and administration.

4. **Effect of Rulings.** Within the limits of the authority conferred, the regulations have all the force and effect of law and are binding upon the taxpayer to the same extent as the statute itself. But the regulations have no force beyond that which is derived from the law as enacted by Congress. A taxing statute must be strictly construed, and the regulations may not lawfully extend the operation of the tax beyond that which is definitely imposed by Congress in the particular language used in the law. Where this is attempted, the taxpayer is entitled to relief in the courts. Except where an appeal to the courts is contemplated, the taxpayer must conform to the rulings of the Treasury Department, and the advice given in this book is directed to that end. The few cases where the position taken in the text differs from that of the Treasury Department are expressly designated. Rulings issued after the publication of this book are contained in the War Tax Bulletin Service provided by the publisher, in which all necessary modifications of the text are pointed out.

TITLE 1. THE INCOME AND WAR EXCESS PROFITS TAX.

5. The Income Tax is levied upon individuals, corporations, business trusts and associations, and estates of certain kinds, but not upon partnerships. The War Profits Tax and Excess Profits Tax apply only to corporations and associations (except where an individual or partnership elects to be taxed as a corporation, as explained at par. 31). These taxes are all based upon the ''Net Income'' which is defined in the law, as discussed under a separate heading in this book, and are assessed upon sworn Returns which it is the duty of each taxpayer to file annually.

PART 1. TAX RATES, EXEMPTIONS, AND APPLICATION.

1. Individuals.

6. **Persons Subject to the Tax.** The Income Tax is not limited to income from business, but applies to every person receiving from any source whatever a net income in excess of the exemptions. Not only citizens and aliens residing in the United States, but also nonresident aliens receiving income from this country and citizens residing abroad, without regard to the source of their income, are covered by the law. Married women and persons not arrived at legal age are taxed.

7. **The Personal Exemption.** Every individual receives a ''personal exemption'' upon which no income tax is paid, in the following amounts: Husband and wife, living together, from their aggregate net income. $2,000; head of a family, $2,000; single person, $1,000; for each dependent (not husband or wife) under 18 years of age or incapable of self support, in addition, $200.

8. **Credit for Dividends and Exempt Interest.** In computing the normal tax, credit is allowed, as shown in the illustration on page 11, and as more fully explained at pars. 116 and 72 of the text, for dividends received upon stock of a corporation which is itself subject to the Income Tax Law, and for interest received upon partly tax exempt bonds. This is after determining the net income and is altogether dif-

ferent from the deductions made for that purpose. These credits do not apply in computing the surtax.

9. **The Normal Tax.** The Income Tax on individuals includes two taxes computed by different methods. There is a tax which applies at the same rate to every individual. This is the Normal Tax. The rates are: $4,000 of Net Income (in excess of exemptions and credits)—1918, 6%—subsequent years, 4%; remainder of Net Income—1918, 12%—subsequent years, 8%. For example, a single person, not the head of a family, will pay no normal tax on the first $1,000 of his net income, 6% on the next $4,000, and 12% on all the remainder, whether his net income is $10,000 or $200,000. If his net income is $6,000, his normal tax will be $360. In addition, he will pay a surtax.

10. **The Surtax.** If the net income of an individual exceeds $5,000, it is subject to the surtax, which is at different rates on successive parts of the income, increasing rapidly as the income grows larger. The personal exemption is not used to compute this tax. For example, if the net income exceeds $5,000, the surtax will amount to 1% on the excess up to $1,000 or a net income of $6,000. If the net income is greater than $6,000, the excess up to $8,000 is taxed 2%, and a higher rate is imposed on each succeeding part of the net income, increasing by 1% for each $2,000 up to $100,000 and then by greater steps to 65%. The Income Tax Table on page 8 shows all the rates of surtax and a convenient method of computation.

11. **Returns Required.** An annual Return (Form 1040), showing in detail the gross income and the net income for the calendar or fiscal year, must be filed by every single person receiving a net income of $1,000 or over during the year, even though the head of a family or for any other reason not subject to tax, and by every married person living with husband or wife where the husband and wife receive an aggregate net income of $2,000 or over during the year. The Return must be filed with the Collector of Internal Revenue for the district in which the taxpayer resides or has his principal place of business, on or before March fifteenth of each year or within two months and fifteen days following the close of the fiscal year. (For further discussion of the Return, see pars. 183-188).

12. **Head of a Family.** Where one person actually supports one or more other related persons either in whole or in part, as a legal or moral obligation, he is for tax purposes the head of a family and has an exemption of $2,000 from the normal tax. For each dependent person (except husband or wife) under 18 years of age or incapable of self-support because mentally or physically defective, the head of a family has an additional exemption of $200. For example: Harley Cotton, a widower, has an adopted son 16 years old and two daughters 19 and 13 years old, respectively, whom he is supporting. His net income is $4,500, so his income tax will be 6% upon $2,100, or $126.

13. **Combined Incomes of Married Persons.** A Return by the husband or wife is required if the combined net income of husband and wife (living together) is $2,000 or more. If a man earns $1,100 and his wife earns $600, no Return is due, but a Return must be filed if he has a net income of $1,800 and she has a net income of $600. If the wife has a separate net income, a Return by her is required; this may be

INDIVIDUAL INCOME TAX TABLE

Showing Total Tax and Convenient Method of Computation

Begin at the first column with the **largest** amount which is **included** in your net income and read across the page.

The figures given are for a **single person** with a personal exemption of $1,000, not receiving any dividends or exempt interest.

For a **married person** or the **head of a family**, find the total tax according to the table, and then **deduct**: $120 and $24 additional for each dependent other than husband or wife, where the net income exceeds the total personal exemption by $4,000 or more; $60 and $12 additional for each such dependent if the net income is between the personal exemption and $5,000. If the net income does not come in either of these classes, compute the tax without using the table.

If the net income includes any **dividends** or **interest** which is **subject to surtax only**, from the amount shown by the table **deduct**: 12 per cent of the amount of such partially exempt income if the *remaining* net income exceeds the personal exemption by $4,000 or more; 6 per cent of such amount if the net income *including* the partially exempt income is less than $4,000 in excess of the personal exemption. If the net income does not come in either of these classes, compute the tax without using the table.

Net Income	Normal Tax	Surtax	Total Tax	Tax on Additional Net Income From	To	Rate*
$ 1,000	None	None	None	$ 1,000	$ 5,000	6%
1,500	$ 30	None	$ 30	1,500	5,000	6%
2,000	60	None	60	2,000	5,000	6%
2,500	90	None	90	2,500	5,000	6%
3,000	120	None	120	3,000	5,000	6%
4,000	180	None	180	4,000	5,000	6%
5,000	240	None	**240**	5,000	6,000	13%
6,000	360	$ 10	370	6,000	8,000	14%
7,000	480	30	510	7,000	8,000	14%
7,500	540	40	580	7,500	8,000	14%
8,000	600	50	650	8,000	10,000	15%
9,000	720	80	800	9,000	10,000	15%
10,000	840	110	**950**	10,000	12,000	16%
12,000	1,080	190	1,270	12,000	14,000	17%
12,500	1,140	215	1,355	12,500	14,000	17%
14,000	1,320	290	1,610	14,000	16,000	18%
15,000	1,440	350	1,790	15,000	16,000	18%
16,000	1,560	410	1,970	16,000	18,000	19%
18,000	1,800	550	2,350	18,000	20,000	20%
20,000	2,040	710	**2,750**	20,000	22,000	21%
22,000	2,280	890	3,170	22,000	24,000	22%
24,000	2,520	1,090	3,610	24,000	26,000	23%
25,000	2,640	1,200	**3,840**	25,000	26,000	23%
26,000	2,760	1,310	4,070	26,000	28,000	24%
28,000	3,000	1,550	4,550	28,000	30,000	25%

*The Surtax rate is 12% less than the rate shown, which is the combined Normal Tax and Surtax.

Net Income	Normal Tax	Surtax	Total Tax	Tax on Additional Net Income From	To	Rate*
$ 30,000..	$ 3,240...	$ 1,810...	$ 5,050....	$ 30,000......	$ 32,000...	26%
32,000..	3,480...	2,090...	5,570....	32,000......	34,000...	27%
34,000..	3,720...	2,390...	6,110....	34,000......	36,000...	28%
35,000..	3,840...	2,550...	**6,390....**	35,000......	36,000...	28%
36,000..	3,960...	2,710...	6,670....	36,000......	38,000...	29%
38,000..	4,200...	3,050...	7,250....	38,000......	40,000...	30%
40,000..	4,440...	3,410...	7,850....	40,000......	42,000...	31%
42,000..	4,680...	3,790...	8,470....	42,000......	44,000...	32%
44,000..	4,920...	4,190...	9,110....	44,000......	46,000...	33%
46,000..	5,160...	4,610...	9,770....	46,000......	48,000...	34%
48,000..	5,400...	5,050...	10,450....	48,000......	50,000...	35%
50,000..	5,640...	5,510...	**11,150....**	50,000......	52,000...	36%
52,000..	5,880...	5,990...	11,870....	52,000......	54,000...	37%
54,000..	6,120...	6,490...	12,610....	54,000......	56,000...	38%
56,000..	6,360...	7,010...	13,370....	56,000......	58,000...	39%
58,000..	6,600...	7,550...	14,150....	58,000......	60,000...	40%
60,000..	6,840...	8,110...	14,950....	60,000......	62,000...	41%
62,000..	7,080...	8,690...	15,770....	62,000......	64,000...	42%
64,000..	7,320...	9,290...	16,610....	64,000......	66,000...	43%
66,000..	7,560...	9,910...	17,470....	66,000......	68,000...	44%
68,000..	7,800...	10,550...	18,350....	68,000......	70,000...	45%
70,000..	8,040...	11,210...	**19,250....**	70,000......	72,000...	46%
72,000..	8,280...	11,890...	20,170....	72,000......	74,000...	47%
74,000..	8,520...	12,590...	21,110....	74,000......	76,000...	48%
76,000..	8,760...	13,310...	22,070....	76,000......	78,000...	49%
78,000..	9,000...	14,050...	23,050....	78,000......	80,000...	50%
80,000..	9,240...	14,810...	**24,050....**	80,000......	82,000...	51%
82,000..	9,480...	15,590...	25,070....	82,000......	84,000...	52%
84,000..	9,720...	16,390...	26,110....	84,000......	86,000...	53%
86,000..	9,960...	17,210...	27,170....	86,000......	88,000...	54%
88,000..	10,200...	18,050...	28,250....	88,000......	90,000...	55%
90,000..	10,440...	18,910...	29,350....	90,000......	92,000...	56%
92,000..	10,680...	19,790...	30,470....	92,000......	94,000...	57%
94,000..	10,920...	20,690...	31,610....	94,000......	96,000...	58%
96,000..	11,160...	21,610...	32,770....	96,000......	98,000...	59%
98,000..	11,400...	22,550...	33,950....	98,000......	100,000...	60%
100,000..	11,640...	23,510...	**35,150....**	100,000......	150,000...	64%
125,000..	14,640...	36,510...	51,150....	125,000......	150,000...	64%
150,000..	17,640...	49,510...	67,150....	150,000......	200,000...	68%
175,000..	20,640...	63,510...	84,150....	175,000......	200,000...	68%
200,000..	23,640...	77,510...	101,150....	200,000......	300,000...	72%
250,000..	29,640...	107,510...	137,150....	250,000......	300,000...	72%
300,000..	35,640...	137,510...	173,150....	300,000......	500,000...	75%
500,000..	59,640...	263,510...	323,150....	500,000......	1,000,000...	76%
1,000,000..	119,640...	583,510...	703,150....	In excess of	$1,000,000...	77%

*The Surtax rate is 12% less than the rate shown, which is the combined Normal Tax and Surtax.

a separate Return or she may subscribe to the joint Return made by both the husband and the wife. If the amount of the wife's income is small, it is acceptable if only the husband signs the Return. The Return should show separately the income received by each.

14. **Exemptions of Husband and Wife.** Husband and wife are entitled to only one exemption, to be deducted from their combined incomes. If the husband deducts the $2,000 exemption and the allowance for dependent children from his separate Return in computing his normal tax, then his wife who files a separate Return is not entitled to any exemption from normal tax. Therefore, the Treasury Department requires that where a husband and wife file separate Returns, they be fastened together. Where one Return includes the income of both husband and wife, the exemption should be deducted from their combined incomes. This personal exemption is designed to cover the essential living expenses, and for this reason is allowed only once in a single family. Where husband and wife are not living together they are to be treated as single persons, and each is entitled to the $1,000 exemption of a single person.

15. **Married Woman's Return.** A married woman may make a separate Return of her own income, and should do so if the net income of her husband or herself exceeds $5,000, as the surtax is imposed upon the separate incomes and the assessment is much more convenient upon separate than upon combined Returns. Apparently the 12% rate applies also to the incomes separately and not combined; that is, both the husband and wife may each receive $4,000 above the exemption, upon which they pay only 6%, before any of the income is taxed at 12%. This law, however, is not clear on this point and the contrary interpretation may be made.

16. **Illustration:** If the net income of the husband is $7,000 and that of the wife is $2,000, the tax is as follows: From the husband's income, $7,000, take the personal exemption, $2,000, and the normal tax is 6% of the first $4,000, or $240, and 12% of the remaining $1,000, or $120, making the total normal tax of the husband $360. The surtax of the husband is 1% of $1,000, plus 2% of $1,000, or $30. The wife receives no additional personal exemption, but her entire net income of $2,000 is taxed at 6%, being less than $4,000. Her normal tax is thus $120, and she is not subject to surtax. The combined tax of husband and wife is $510 on an aggregate income of $9,000. See also Illustration on opposite page.

17. **Exemptions to a Deceased and Surviving Spouse.** A married man dies in 1918. His executor must make a Return of the income he received during 1918 up to the date of his death, and may deduct therefrom the exemption of $2,000. This situation does not appear to be covered by the provision for reducing the exemption when the Return covers less than twelve months because of a change in the fiscal year. The surviving wife must make a Return of the income she has received during the calendar year, and may deduct therefrom the exemption of $1,000.

18. **Exemption Fixed by Status at the End of the Year.** The status of the taxpayer, for the purpose of the exemption, is determined

Illustration of Computation of Net Income and Income Tax of Husband and Wife

Gross Income:

Salary or professional income	$15,000.00	
Profit on sale of bonds	500.00	
Rents from apartment house	7,200.00	
Interest on savings account, personal loans and corporate bonds not "tax free"	1,200.00	
Income of wife from similar interest	400.00	
Interest on corporation bonds containing "tax free" covenant, no exemption claimed	400.00	
Interest on Third Liberty Loan Bonds: Amount of principal owned, $40,000. Exempt, $5,000, and in addition, for two years after war, $15,000. Interest on $20,000 taxable	850.00	
Interest on Fourth Liberty Loan Bonds, $10,000 held, exempt until two years after the war.		
Interest on First Liberty Loan $3\frac{1}{2}$'s and municipal bonds, exempt.		
Dividends on corporate stock	1,800.00	
Dividends received by wife	200.00	
Stock dividends, exemption claimed.		
Total Gross Income		$27,550.00

Deductions From Gross Income:

Expenses of Business:—		
Transportation to business	$ 60.00	
Maintenance and operation of apartment house	2,248.82	
Interest on personal indebtedness	45.00	
Taxes on real estate	863.27	
Losses on sales of stocks and bonds	1,350.00	
Loss by theft of overcoat	60.00	
Debt ascertained to be worthless; note five years overdue, debtor without assets	650.00	
Depreciation of apartment house at 2% on original cost of $75,000	1,500.00	
Contributions to charities, $3,500, reduced to 15% of net income without this deduction	3,115.94	
Total Deductions		$ 9,893.03
Net Income of Husband and Wife		$17,656.97

Net Income		$17,656.97
Credits for Normal Tax:		
Personal Exemption:—		
For married man	$ 2,000.00	
For two dependent children	400.00	
Dividends	2,000.00	
Liberty Bond Interest	850.00	
Total Credits		$ 5,250.00
Net Income subject to Normal Tax		$12,406.97
Net Income of Wife subject to Normal Tax		400.00
Net Income of Husband subject to Normal Tax		$12,006.97
Net Income of Wife subject to Surtax		None
Net Income of Husband subject to Surtax		$17,056.97

Normal Tax:

On Net Income of Wife	$ 400.00	@	6%	$ 24.00	
On Net Income of Husband:—					
First	4,000.00	@	6%	240.00	
Remaining	8,006.97	@	12%	960.84	
Total Normal Tax on	$12,406.97				$ 1,224.84
Credit tax paid at source on tax free bonds					8.00
Balance of Normal Tax due					$ 1,216.84

Surtax:

On	$16,000.00			$ 410.00	
On remaining	1,056.97	@	7%	73.99	
Total Surtax on	$17,056.97				483.99
Total Income Tax on	$17,656.97				$ 1,700.83

as of December 31 of the year for which the Return is made. A man who marries on December 30 is entitled to deduct the full amount of the exemption applicable to the head of a family.

19. **Minors.** A parent may include in his Return the income of dependent minor children. Compensation earned by such children is income of the parent. As to such income, there is no personal exemption for the minor. A minor receiving income from property held as his separate estate or compensation for his services after his emancipation, or other income not subject to appropriation by his parent, must file a separate Return and may claim a separate exemption.

20. **Nonresident Aliens.** A citizen or subject of a foreign country who does not reside in this country is a nonresident alien and is taxed upon the income received from sources in this country. An alien residing in the United States and a citizen residing abroad are taxed upon their entire income, including that received from foreign sources. Citizenship is conferred only by completed naturalization, not by so-called "first papers." An alien is not a nonresident if he has made his home in this country and has no intention of returning to any former home, but if he is temporarily living in the United States, intending to leave it at some indefinite time or upon the termination of the purpose for which he came here, he is a nonresident alien. From the income received from sources in this country, a nonresident alien is allowed deductions similar to those allowed to residents, but only to the extent that they are connected with property in this country or income received from this country, and only if he files a Return giving all the information required by the Commissioner. The personal exemptions of $1,000 or $2,000 shall not be allowed if the country of which the nonresident alien is a citizen or subject imposes an income tax and does not allow a alien, thought to be a nonresident, denies that he is subject to such country. Nonresident aliens do not receive the benefit of the lower rate of normal tax applicable to the first $4,000 of taxable net income, but the higher rate only is used. Every person in this country paying salary, rent, interest, or other fixed or determinable annual or periodical income (except dividends or interest on tax free bonds) to a nonresident alien must withhold and pay a tax of 8% on such income. Where an alien, thought to be a nonresident, denies that he is subject to such withholding, he may be required to execute a certificate (Form 1078) which will protect the employer or other person in paying income in full.

2. Corporations and Associations.

21. **Definition.** The term "corporation" refers not only to the ordinary statutory corporations but also to business trust associations, called "Massachusetts Trusts," joint stock companies, limited partnerships, mutual savings banks and insurance companies, and all analogous business associations, the net income of which is distributed among the members on the basis of the shares which each holds or the proportion of capital which each has invested. (For "personal service" corporations, see par. 30). Corporations organized in this country are taxed upon their income received from all sources; corporations organized in foreign countries are taxed upon the net income received from sources in this country only.

22. **Kinds of Taxes on Income.** The net income of a corporation is subject to two distinct taxes, the Profits Tax and the Income Tax, involving four different plans of taxation, each plan with different rates, exemptions, credits, and methods of computation. The Profits Tax is a combination of an Excess Profits Tax, directed at the excess over a fixed return upon the invested capital, and a War Profits Tax based upon the difference between the income of the prewar years and that of the current taxable years. The Profits Tax equals the greater of the two amounts, except that it may not exceed a maximum determined at a flat rate upon a different plan, which is explained as the third method. The Income Tax, which is the fourth method, is levied at a flat rate upon the taxable income in excess of the stated exemptions. Every corporation must ascertain its liability with respect to all four of these methods of taxation, although only one Profits Tax is finally assessed after the method of computation which is applicable has been selected. The Income Tax is in addition to the Profits Tax. Lower rates are fixed for 1919 and subsequent years, except that any corporation which receives, in any year after 1918, net income of $10,000 or more from government contracts made between April 6, 1917, and November 11, 1918, inclusive, shall be subject to the 1918 Profits Tax upon such income. The following table shows the rates which apply to the income of 1918 and also of 1919 and subsequent years. See also the Illustrations at page 14, which show the method of computation.

CORPORATION TAX RATES

	1918	Subsequent years.
Profits Tax:		
Method 1. Excess Profits Tax.		
Excess Profits Credit (par. 23)	Not taxed.	Not taxed.
First Bracket—Net Income in excess of Credit and not in excess of 20% of Invested Capital	30%	20%
Second Bracket—Remainder of Net Income	65%	40%
Method 2. War Profits Tax.		
Third Bracket—The Excess Profits Tax is deducted from the War Profits Tax, and the difference is the Third Bracket of the Profits Tax. This Bracket applies only where the War Profits Tax is greater than the Excess Profits Tax, in which event the total of the three Brackets will equal the War Profits Tax.		No War Tax Profits after 1918.
War Profits Credit (par. 24)	Not taxed.	
Remainder of Net Income	80%	
Method 3. Maximum Profits Tax.		
Applies when less than the amount found by above method.		
Net Income between $3,000 and $20,000	30%	20%
Net Income in excess of $20,000	80%	40%
Income Tax:		
Method 4. Income Tax. In addition to the Profits Tax.		
Income Tax Credit (par. 26)	Not taxed.	Not taxed.
Remainder of Net Income	12%	10%

ILLUSTRATION OF
Computation of Invested Capital and Net Income
OF CORPORATION

INVESTED CAPITAL

Capital and Surplus:			
Capital stock, paid up and outstanding March 3, 1917, and January 1, 1918		$900,000.00	
Surplus, January 1, 1918		450,000.00	
Undivided profits, January 1, 1918		106,926.50	$1,456,926.50
Adjustments:			
Cash paid in for stock, $100,000 at par. Bonus stock given with stock sold for cash		$100,000.00	
Tangible property paid in for stock:			
Par value of stock issued	$200,000.00		
Actual value of property when acquired	150,000.00	50,000.00	
Intangible property paid in for stock:			
Par value of stock issued for all property of a going business in 1905	$500,000.00		
Proved value of tangible property	150,000.00		
Par value of stock issued for good will and patents	$350,000.00		
Actual value when acquired ($600,000) 25% of outstanding capital stock	175,000.00	175,000.00	$ 325,000.00
Invested capital at beginning of year			$1,131,926.50
Changes:			
Dividend paid February 20, 1918, $45,000 for 10 1-3 months			37,500.00
Dividend paid August 20, 1918, $45,000, covered by current profits.			
Average for year			$1,094,426.50
Inadmissible Assets:			
Total assets, average for year		$2,873,528.00	
Inadmissible assets, average for year		563,296.00	
Ratio of inadmissible assets to total assets		19.6%	
Deduction of 19.6% of average invested capital			214,507.51
Invested Capital, admissible average			$ 879,918.99

NET INCOME

Gross Income:		
Sales	$1,545,214.00	
Interest on bank balance	350.00	
Interest on corporate bonds	2,464.00	
Interest on Liberty Bonds:		
Third Loan ($32,500 held, $12,500 exempt), first coupons on $20,000.	298.00	
Fourth Loan ($5,000 held), no interest received.		
Dividends from other corporations. Exempt.		
		$1,548,326.00
Deductions:		
Net cost of goods sold	$ 619,592.00	
Expenses	186,725.36	
Interest paid	192,317.00	
Losses on bad debts, sale of permanent assets, etc	18,462.00	
Depreciation	41,690.00	
Taxes (excluding $91,430 Federal income tax paid)	17,473.00	
		$1,076,259.36
Net Income		$ 472,066.64

Illustrations of Computation of Corporation Taxes.

CASE 1—EXCESS PROFITS TAX

Net income for 1918 (see opposite page for computation)			$472,066.64
Invested capital (see opposite page for computation)			879,918 90
Invested capital for prewar period:	1911	$ 498,180.00	
	1912	533,896.00	
	1913	678,756.00	
Total and average		$1,710,832.00	$570,277.33
Increase in invested capital			$309,641.57
Net income for prewar period:	1911	$ 342,762.00	
	1912	481,290.00	
	1913	512,687.00	
Total and average		$1,336,739.00	$445,579.67

Method 1.—Excess Profits tax:	Income	Rate	Tax
Specific exemption	$ 3,000.00		
8% of invested capital	70,393.51		
Excess profits credit	$ 73,393.51		
Above credit and under 20% of invested capital ($175,983.78)	102,590.27	30%	$ 30,777.08
Above 20% of invested capital	296,082.86	65%	192,453.86
	$472,066.64		$223,230.94
Method 2.—War Profits Tax:			
Specific exemption	$ 3,000.00		
10% of invested capital ($87,991.89)			
Prewar income	445,579.67		
10% of increase in invested capital	30,964.15		
War profits credit	$479,543.82		
No income subject to War Profits Tax.			
Method 3.—Maximum Profits Tax:			
Specific exemption	$ 3,000.00		
Between $3,000 and $20,000	17,000.00	30%	$ 5,100.00
Over $20,000	452,066.64	80%	361,653.31
(Maximum does not apply)	$472,066.64		$366,753.31
Method 4.—Income Tax:			
Exempt Liberty Bond interest	$ 298.00		
Specific exemption	2,000.00		
Credit for profits tax	223,230.94		
Remainder of net income	246,537.70	12%	$ 29,584.52
	$472,066.64		
Total Income and Profits Tax			$252,815.46

CASE 2—WAR PROFITS TAX

Net income for 1918	$1,167,677.02
Invested capital for 1918	2,207,517.04
Average annual net income for prewar period	69,346.97
Average invested capital for prewar period	1,788,558.37
Increase in invested capital since prewar period	418,958.67

Method 1.—Excess Profits Tax:	Income	Rate	Tax
Specific exemption	$ 3,000.00		
8% of invested capital	176,601.36		
Above credit and under 20% of invested capital	261,902.04	30%	$ 78,570.61
Above 20% of invested capital	726,173.62	65%	472,012.85
Total net income and excess profits tax	$1,167,677.02		$550,583.46
Method 2.—War Profits Tax:			
Specific exemption	$ 3,000.00		
(a) Average prewar income plus 10% of increase in invested capital since prewar period ($111,242.84).			
(b) 10% of invested capital for 1918	220,751.70		
Income in excess of credit	943,925.32	80%	$755,140.25
	$1,167,677.02		
Total Profits Tax (equals the War Profits Tax, and not the Excess Profits Tax, because that is the larger figure)			$755,140.25
Method 4.—Income Tax:			
Specific exemption	$ 2,000.00		
Credit for profits tax	755,140.25		
Remainder of net income	410,536.77	12%	$ 49,264.41
	$1,167,677.02		
Total Income and Profits Tax			$804,404.66

23. **Excess Profits Credit.** The credit for the Excess Profits Tax consists of a specific exemption of $3,000 plus 8% of the invested capital, the determination of which is separately discussed. Only the net income in excess of this credit is subject to the Excess Profits Tax. In all cases of Return covering less than twelve months, the credit will be proportionately reduced.

24. **War Profits Credit.** The War Profits rate applies only to the net income which exceeds a credit consisting of a specific exemption of $3,000 plus the prewar profits, adjusted with reference to changes in the invested capital. If the invested capital for the taxable year is greater than the average for the prewar period, the credit for the prewar income is increased by 10% of the additional capital. If the invested capital has been reduced since the prewar period, 10% of the difference between the invested capital for the current year and the average for the prewar period is deducted from the amount of the prewar income. If the prewar income as so adjusted is less than 10% of the average invested capital for the taxable year, the credit will consist of the sum of $3,000 plus 10% of the invested capital. A corporation which accepts the minimum allowance of 10% need not report as to the prewar conditions. In all cases of Returns covering less than twelve months the credit will be proportionately reduced. The prewar income is the average net income for the calendar years 1911, 1912, and 1913, but including only as many of such years during the whole of which the particular corporation (or its predecessor business) was in existence. Thus for a corporation organized in February, 1912, and not the successor to a business previously in existence, the prewar period is the calendar year 1913, no matter how much income may have been earned during 1912. The net income shall be the same amount as that reported on the returns made under the tax laws of 1909 and 1913, except that the federal tax then allowed as a deduction shall be added and dividends not exempt in 1913 must be deducted for that year. A net loss for any one year is not included in finding the average, which is based only upon annual net income. Thus if a corporation had a net income of $60,000 for 1911, a net loss of $10,000 for 1912 and a net income of $10,000 for 1913, the average prewar income is $35,000.

25. **War Profits Credit of a New or Reorganized Business.** Where a new corporation is the successor to a business previously conducted by an individual, partnership, or corporation, in case of a reorganization, consolidation, or change of ownership, the income and invested capital of the predecessor business for the prewar period shall be used in computing the War Profits Tax of the new corporation. For example, a business owned for many years by Harvey Elston was sold in 1916 to a new corporation in which Elston had no interest. The new corporation must either accept the minimum allowance of 10% or must report the net income and invested capital of Harvey Elston for each of the years 1911, 1912, and 1913, in order to determine its War Profits Credit. In such a case, the net income of the prior business shall be ascertained as nearly as possible upon the same basis as provided for corporations under the present law, with a reasonable deduction for salary or compensation to the individual proprietor or members of the partnership for

services actually rendered. In computing the invested capital in such a case the necessary adjustments may be made to establish a common basis with respect to assets valued differently or excluded from the invested capital before the reorganization. A new corporation which is not a continuation of a previous business and which was not in existence during the whole of at least one calendar year during the prewar period, that is, was formed after January 1, 1913, receives a War Profits Credit consisting of the specific exemption of $3,000 plus a ''constructive'' prewar income, equal to the same percentage of its invested capital for the taxable year, but not less than 10%, as the average percentage of net income to invested capital for the prewar period in the case of corporations engaged in a trade or business of the same general class as that conducted by the new corporation. If this average percentage has not been published by the Commissioner of Internal Revenue at least thirty days prior to the time when the Return is due, then the Return shall be made out by using 10%, to be replaced by the average percentage when determined. If at any time during the taxable year a majority of the stock of a new corporation is owned or controlled directly or indirectly by a corporation which was in existence during the whole of at least one calendar year during the prewar period or if 50% or more of the gross income of a new corporation is derived from Government contracts made between April 6, 1917, and November 11, 1918, then these provisions shall not apply, but the War Profits Credit shall be $3,000 plus 10% of the invested capital, instead of the average percentage.

26. **Income Tax Credit.** Before computing the Income Tax, credit is allowed for the amount assessed as Profits Tax for the same taxable year. In addition, there is a specific exemption for a domestic corporation of $2,000 and the net income is also reduced by the amount of partially exempt interest (such as that upon Liberty Bonds), which is subject to the Profits Tax, but not to the Income Tax. When the Return covers less than twelve months, the specific exemption is proportionately reduced.

27. **Profits Tax Fixed by Comparison.** The chief means provided by the law for preventing inequality and hardship in the assessment of the Profits Tax, is the use of a rate found by comparison with representative corporations rather than the rates of the law based upon the actual invested capital. This ''comparative rate,'' as it may be called, is the same percentage or proportion of the net income of the corporation in question, as the percentage of Profits Tax to net income in the case of representative corporations engaged in a similar business whose invested capital can be satisfactorily determined and which are similarly circumstanced as to gross income, net income, profits per unit on business transacted and capital employed, amount and rate of war profits or excess profits and all other relevent facts. For example, if the Profits Tax of representative corporations in the manufacturing hardware business is 17% of the net income, in the case of any manufacturing hardware business where any of the following conditions exist, the Profits Tax will be 17% of the net income.

28. **Application of the Comparative Rate.** The Profits Tax will be assessed at the comparative rate in the following cases: (1) Where the

Commissioner is unable satisfactorily to determine the invested capital. (2) In the case of foreign corporations. (3) Where a mixed aggregate of tangible and intangible property has been paid in for stocks and bonds and the Commissioner is unable to determine the respective values of the several classes of property at the time of payment or to distinguish the property paid in for stock from that paid in for bonds. (4) Where the Commissioner finds, upon application of the corporation, that if the tax were determined by the general rule of the law it would, owing to abnormal conditions affecting the income or capital of the corporation, work upon the corporation an exceptional hardship, evidenced by gross disproportion between the rate of the tax so computed and the rate of tax in the case of representative corporations. This last provision shall not apply to any case (a) in which the tax is high merely because the corporation earned during the year a high rate of profits upon a normal capital, nor (b) in which the 50% or more of the gross income was derived from government contracts on a cost-plus basis or made between April 6, 1917, and November 11, 1918. The facts calling for the application of the comparative rate should be set forth in a sworn claim filed by the taxpayer with the Return or subsequently. The Return must show the tax as computed without the benefit of this provision. If the tax so computed is less than 50% of the net income, the first installment, pending the decision upon the claim, shall be based upon the tax so computed. If such tax is 50% or more of the net income, the installments shall temporarily be based upon a tax equal to 50% of the net income. Adjustment will be made in all cases after the tax liability has finally been determined, and if it exceeds 50% of the net income the excess of the correct installments over the amounts actually paid shall be due with interest at ½% per month.

29. **Tax for Fiscal Year or Part of Year.** Where the Return of a corporation covers a fiscal year, the invested capital, the net income, and the income and profits tax for the entire fiscal year will be computed under the law applicable to the first part of the fiscal year and again under the law applicable to the last part of the fiscal year. Each tax will then be divided in proportion to the number of months falling in each of the calendar years. Actual earnings during the particular months may not be considered. Thus a corporation which has made a Return covering a fiscal year ending on April 30, 1918, must file an amended Return showing the invested capital, net income, and tax for the entire year computed under the new law. One third of the tax shown to be due by the amended Return will be assessed for the first four months of 1918, and this amount will be credited with one-third of the tax shown to be due by the original Return and previously paid. Similarly, when filing the Return for the fiscal year ending on April 30, 1919, the tax must be computed both under the 1918 and 1919 rates, and two-thirds of the first amount and one-third of the latter amount will be payable. Where a corporation is doing business for only part of the taxable year, where the basis of the Return changes from calendar to fiscal year or from one fiscal year to another, and in all other cases where a Return covers less than a year, the credits allowed for the various taxes shall all be reduced in proportion to the number of months covered by the

Return (except that the $2,000 specific exemption for Income Tax need be reduced only where there is a change in the fiscal period on which the Return is based, and not in case of a Return for a portion of a year for some other cause).

30. **Personal Service Corporations.** A special plan of taxation is adopted for certain corporations in which services rendered, rather than capital employed, is the material factor in producing income. Such corporations must file Returns but are not subject to either the Income Tax or the Profits Tax, and the individual stockholders are taxed upon their respective shares of the net income, whether divided or not, in the same manner as members of a partnership. Only those corporations come within these provisions whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the business. A similar test has been held to exclude barber shops and photograph studios unless the principal owners were actively engaged as barbers or photographers. The statute further excludes corporations where capital (whether invested or borrowed) is a material income-producing factor or where 50% or more of the gross income consists of profits or commissions derived from (1) trading as a principal or (2) from government contracts made between April 6, 1917, and November 11, 1918, inclusive, for the benefit of the United States with any department, officer, agency, or contractor, of or for the government. Where only part of the net income of a corporation is derived from a personal service business, and the other part from a business requiring invested capital, the income from the personal service business is not exempt. But where not less than 30% of the net income is derived from a separate business or distinctly separate branch of the business which is a personal service business, the Profits Tax is first computed on the portion of the income which is derived from capital, with a proportionate reduction of the Profits Tax credits, and the percentage rate of such tax to such income, if not less than 20%, will apply to the income from the personal service business. If such rate is less than 20%, the Profits Tax upon the personal service income will be 20%, except where the Profits Tax, computed upon the aggregate income and capital as in any other case is less than 20%, in which event that method shall be used. The corporation Income Tax applies to the entire net income where any portion of it is derived from a personal service business.

31. **Incorporation Retroactively Effective.** Special provision is made for applying the corporation taxes to the income of a business owned by an individual or partnership during 1918, but incorporated before July 1, 1919. This section applies only to a business in which capital is a material income-producing factor and in which the net income for 1918 was not less than 20% of the invested capital. At the option of the individual or partnership proprietor, the net income of the business from January 1, 1918, to the date of incorporation will be subject to the Income and Profits Tax as if it was the net income of a corporation and the net income and invested capital shall be computed as for a corporation. Such income will not then be subject to the individual income tax, except that the surtax will apply to any profits earned after Jan-

uary 1, 1918, when drawn out or distributed. Where this section is applied, the Capital Stock Tax from the period after January 1, 1918, shall also be paid.

32. **Affiliated Corporations and Consolidated Returns.** Where two or more corporations are affiliated within the statutory definition, the Income Tax and Profits Tax are determined on the basis of a consolidated Return. In this return all the corporations are treated as one business with one income and one invested capital, which is entitled to only one of each of the various specific credits. In computing income and capital, all intercompany accounts and investments in subsidiaries are eliminated. The tax is assessed against the various companies in such proportion as may be agreed upon among them, or in proportion to the respective net income where there is no agreement. The consolidated Return is required (1) where one corporation owns or controls substantially all of the stock of the other or others and (2) where substantially all of the stock of the affiliated corporations is owned or controlled by the same interests. In a similar connection the Department has held that ''substantially all of the stock'' means 95% or more. No consolidated Return shall include the net income or invested capital of a corporation which was organized after August 1, 1914, and was not the successor to a then existing business and which derived 50% or more of its gross income from government contracts made between April 6, 1917, and November 11, 1918.

33. **Exempt Corporations.** The following corporations and organizations are exempt from the Income Tax, and also from the Profits Tax: (1) labor, agricultural, or horticultural organizations; (2) mutual savings banks not having a capital stock represented by shares; (3) fraternal beneficiary societies, orders, or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents; (4) domestic building and loan associations and co-operative banks without capital stock organized and operated for mutual purposes and without profit; (5) cemetery companies owned and operated exclusively for the benefit of their members; (6) corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; (7) business leagues, chambers of commerce, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or individual; (8) civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare; (9) clubs organized and operated exclusively for pleasure, recreation, and other non-profitable purposes, no part of the net earning of which inures to the benefit of any private stockholder or member; (10) farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or co-operative telephone companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues,

and fees collected from members for the sole purpose of meeting expenses; (11) farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them; (12) corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title; (13) federal land banks and national farm-loan associations; (14) personal service corporations.

34. **Exemption Conditional.** A corporation which is exempt by the above provisions only if no part of the net earnings inures to the benefit of any private stockholder or upon any similar condition, must establish its right to be exempt by filing with the collector of internal revenue affidavits showing the purpose and nature of the organization, the source of its income, the disposition of the same, and other information to establish the required condition. Thereafter, no Return is required.

35. **Particular Corporations Not Exempt.** If a corporation does not come within one of the classes described, it is not exempt merely because it is organized not for profit. A corporation formed as a family affair to hold property together is not exempt. Subsidiary corporations are regarded as distinct entities, and are not exempt because they are owned by a holding corporation which pays income tax when it receives the earnings of the subsidiary. Nor is a corporation exempt because it is owned by and is a subsidiary of a corporation within one of the exempted classes. The exemption for "agricultural or horticultural organizations" does not include a corporation engaged for profit in agricultural pursuits, such as the ownership and operation of sugar plantations. Cemetery companies are not exempt if operated for profit. Mutual insurance companies receiving income other than assessments or dues for the sole purpose of meeting expenses are taxed upon such income. Co-operative stores or merchandising organizations are not exempt.

36. **Returns Required.** Every corporation not entirely exempt (under par. 33) and every personal service corporation must file an annual Return (on Form 1031) showing in detail its gross and net income for the calendar or fiscal year. This is required even though the corporation is not subject to tax, as where its net income is less than the exemption and credits. If the net income is $3,000 or more, a Return for the Profits Tax (Form 1103) is also required. The Returns must be sworn to by the president or principal executive officer and also by the treasurer or principal financial officer, and must be filed on or before March 15 of each year, or if they cover a fiscal year, on or before the fifteenth day of the third month following the end of such fiscal year. They are filed with the collector of internal revenue for the district in which is located the principal office of the corporation, where are kept its books of account and other data from which the Return is prepared. (For a further discussion of the Return, see pars. 183-188).

37. **Foreign Corporation.** A corporation organized under the laws of a foreign country, even though it has offices or plants in the United States, is taxed only upon the net income received from sources in this country. Domestic corporations are taxed upon their entire income from all sources, even though they may have most of their capital invested in other countries and may receive most of their income from abroad. A foreign corporation may deduct from its gross income received from sources in this country the general deductions allowed by the statute, to the extent that they are connected with the taxable income. A foreign corporation is not allowed the $2,000 exemption from Income Tax nor the $3,000 exemption from Profits Tax. If a foreign corporation is not engaged in trade or business in this country and has no office or place of business here, a tax of 10% must be withheld and paid on its behalf by the person in this country who makes the payment of any fixed or determinable annual or periodical income (except interest on tax free bonds and dividends) to such foreign corporation. The corporation itself then pays the balance of the tax.

3. Estates and Fiduciaries.

38. **Estates Taxed as Entities.** Whenever an estate receives any income which is not received for distribution to known beneficiaries, it is taxed upon such income as if it were an individual. The Return (Form 1040) must be filed and the net income is determined in the same way. It is subject to the normal tax and the surtax, and the same credits are allowed, including the personal exemption of $1,000. This applies to: (1) Estates of deceased persons receiving income during the period of administration or settlement of the estate; (2) Income accumulated in trust (a) for the benefit of unborn or unascertained persons, or persons with contingent interests and (b) for future distribution to beneficiaries known or unknown. It does not apply to income collected by a guardian, to be distributed as directed by the court. Profits realized by a sale of property of the estate is to be included. The income upon which the estate has been taxed becomes a part of the estate and is not subject to any further income tax when it is subsequently distributed.

39. **Returns of Fiduciaries.** Where the income of an estate is to be distributed periodically, whether at regular intervals, at the convenience of the fiduciary, at the request of the beneficiary, or at periods determined in any other way and not amounting to an accumulation, the income is not taxed to the estate but only to the beneficiary, whose individual Return must show his share in such income whether distributed and paid to him or not. The fiduciary must, however, make an annual Return (Form 1041) showing the net income of the estate, computed the same as for an individual, and the share of every beneficiary therein, whether distributed or not, in every case where the net income of the estate is $1,000 or over, or where any beneficiary has a net income of $1,000 or over, or $2,000 if married, or is a non-resident alien. The term ''fiduciary'' includes a guardian, trustee, executor, administrator, receiver, conservator, or any person holding in trust in a similar capacity an estate in which another person has the beneficial interest.

It does not include a person acting under a power of attorney although in full control of the property of his principal, nor a receiver in possession of only part of the property of an individual. Any one of joint fiduciaries may execute the Return. Where there is one trustee acting in various trusts created by the same person, one Return should be filed, although the trusts may have been created by different instruments and have different beneficiaries. This does not apply to separate trust estates which are subject to taxation as entities. Where a trustee acts in various trusts for the same beneficiaries, but created by different persons, separate Returns must be filed for each estate.

40. **Fiduciaries as Agents.** A fiduciary acting for a minor or an incompetent person is required to file the individual Return (Form 1040) of such person, as his agent, which is in addition to the Return (Form 1041) required of the fiduciary. An executor or administrator must file the individual Return (Form 1040) of a person dying within the year who received during the year a net income of $1,000 or over if single, or $2,000 or over if married. This is in addition to the Return (also on Form 1040) required of the fiduciary to show the income received by the estate subsequent to the death and before the end of the year. A receiver, assignee, trustee in bankruptcy, or other fiduciary, if operating the property or business of a corporation, must make a Return for the corporation (Form 1031) and pay the tax on its behalf.

4. Partnerships.

41. **Must File Returns.** Although a partnership itself is not taxed on its income, the law requires every partnership to file a Return (Form 1065) showing its gross income and net income, which is determined according to the requirements of the Income Tax Law. Apparently the Return must be filed even though the firm has no net income for the year. Any one of the partners may sign and swear to the Return, which is subject to the general requirements for Returns (stated at pars. 183-188), and may cover the calendar year or a fiscal year as in the case of individuals and corporations. The Return must show the name and address of each partner and his share in the net income of the firm. This amount must be included in the taxable income of the partner, as shown on his individual Return, without reference to the amounts actually received by him as distributions of the firm's earnings. A partnership which is reorganized by incorporating after January 1, 1918, and before July 1, 1919, may at its option be taxed as a corporation after January 1, 1918, paying the Income Tax, Profits Tax, and Capital Stock Tax (read par. 31).

PART 2. DETERMINATION OF INVESTED CAPITAL.

42. **Distinguished from Capital Stock or Capital Employed.** The invested capital which is used in computing the Profits Tax must be determined in accordance with the statutory provisions and may be an amount entirely different from the ''capital'' as determined for other purposes and by other standards. Two general rules underlie the requirements as to invested capital: (1) It consists of the amount invested by

the owners at the time the business was organized or subsequently, valued as of the time of investment rather than as of the present time; (2) property of certain kinds invested in the business may be included in the invested capital only to a limited extent. In addition, the invested capital must be reduced where part of it is invested during the taxable year in property which produces a tax-exempt income. The invested capital should be determined by carefully following the directions on the Return, which indicate in general the following method of procedure.

43. **Paid Up Capital Stock.** While the invested capital is not in all cases represented by the paid up capital stock, this is the starting point for its determination. Shares issued upon unpaid subscription or otherwise entirely without consideration cannot, of course, represent invested capital. Where stock subscriptions are paid in good faith with enforceable notes bearing a reasonable interest, the notes may be considered as tangible property paid in for the stock, but if there is any agreement or understanding that the notes shall be paid only out of the profits of the company, or if the interest or principal is not paid within a reasonable time, the notes will be held merely colorable and will be excluded. Where stock subscriptions or notes are actually paid by crediting profits or dividends, this is equivalent to the payment of cash, which is included in invested capital from the date of payment. Even though all of the outstanding capital stock has been fully paid for, the time and method of payment must nevertheless be analyzed, for such adjustment as may be necessary to comply with the statutory restrictions.

44. **Paid-In Surplus and Undivided Profits.** To the paid-in capital of the company is added the paid-in or earned surplus as of the first day of the taxable year. The earnings so included must first be reduced by the amount of any net loss or accumulated deficit, but the capital originally paid in need not be reduced on this account. Profits earned during the taxable year, even though remaining in the business, may not be included in the invested capital, but if such profits are distributed in cash which is then reinvested, the invested capital is apparently increased. Paid-in surplus must be analyzed in the same way as paid-in capital stock, and earned surplus or undivided profits must be analyzed to establish that it is not merely a book surplus but an actual addition to the investment of the owners. To this end, the accounts of the company back to the date of its organization are subject to examination, in order to determine that depreciation allowances have at all times been adequate to represent the actual reduction of profits on this account, that obsolescence has been properly recognized, that discarded property has been charged against the profits, and that no amount has been added by marking up property or revaluing assets, and that in all other respects the surplus represents actual earnings. On the other hand, adjustment of the surplus in favor of the taxpayer will be made where the book surplus has been reduced by marking down assets which have not actually depreciated or disappeared.

45. **Borrowed Capital.** The definition of invested capital expressly excludes borrowed capital. Where a business is actually conducted upon

borrowed money or upon the strength of its credit, its invested capital is not thereby increased, although this may serve as the reason for assessing the tax at the comparative rate explained above. Even though money is loaned to a corporation by its shareholders, it does not become invested capital if it remains a debt, payable with the other debts of the corporation in priority to the capital liability of the company. Where money is advanced by stockholders under an agreement that their claim shall be postponed to all other creditors but shall come before the other stockholders, an interest somewhat like that of a preferred stockholder is created and, possibly, such amounts may be regarded as invested capital. They are, however, in form borrowed capital and the general rule is that the capital of a corporation must be represented by its legally issued shares of stock, and must belong to the holders of its shares in proportion to the stock held by them.

46. **Paid-In Cash as Capital.** The invested capital of a corporation includes without limit the amount of cash paid in for its stock or shares or paid in to become the surplus of the corporation. The amount so paid in may be more or less than the book capital, which must then be adjusted accordingly. The capital originally paid in need not be reduced on account of any net loss, accumulated deficit, or other impairment of capital not resulting in a return to the stockholders.

47. **Good Will and Intangible Property as Capital.** The invested capital may include only a limited amount of intangible property paid in as the consideration for the issues of stock or shares. Where such property was purchased for cash or its equivalent, no limit applies. Good will and similar property developed in the business may not be included in the invested capital, but it is necessary that it be specifically purchased or paid in. As used in this connection, intangible property means good will, trade marks, brands, patents, copyrights, processes, franchises, and other like property, but does not include stocks, bonds, notes, leaseholds, insurance policies, and other property commonly described as intangible property but defined as tangible property by the Profits Tax Law. Where stock was issued for such intangible property, the amount included in the invested capital must not exceed any one of the following maximums and the excess, if any, must be deducted from the capital and surplus: (1) as to each item or parcel of such property, the lower of either (a) the actual cash value of the property at the time paid in or (b) the par value of the stock or shares issued in payment for the property, which in the case of stock or shares issued at a nominal value or having no par value, shall be the fair market value of the stock as of that date; (2) the aggregate of all such property paid in prior to March 3, 1917, may not exceed 25% of the par value of the total outstanding stock on that date; (3) the aggregate of all such property paid in before or after March 3, 1917, may not exceed 25% of the par value of the total outstanding stock at the beginning of the taxable year.

48. **Tangible Property as Capital.** Tangible property, which includes all property other than that defined by the law as intangible property, may be included in the invested capital to the full amount of its actual

value at the time paid in for stock or shares. Where the taxpayer satisfactorily shows that the actual cash value at that time was clearly and substantially in excess of the par value of the stock or shares specifically issued for such property, the excess may be treated as paid-in surplus to be added to the book capital and surplus. The fact that property may have substantially increased in value after having been paid into the corporation is not material, as any increase in the value of the property of the corporation does not add to its invested capital until realized by sale or disposition of the property; only in this way does it become a part of the undivided profits or surplus. To illustrate:—If a coal mine, of the proved value of $250,000 in 1903 and $500,000 in 1917, was conveyed to a corporation in 1903 as payment for its entire stock of the par value of $100,000, the invested capital of the corporation will be increased to $250,000 upon a claim for $150,000 as paid in surplus, but will not include the addition in value occurring in later years. A similar addition to paid in surplus with respect to property purchased by the corporation for cash rather than taken for stock has been allowed by the Regulations issued under the 1917 law, and apparently is not inconsistent with the new law.

49. **''Mixed Aggregate'' of Good Will and Other Property.** Where a corporation is formed to take over a going business, it may acquire a mixed aggregate of tangible assets and intangible assets, including the good will of the former business. If such a mixed aggregate was purchased with cash, the invested capital is not affected, since the cash paid in remains the invested capital. But where such a mixed aggregate has been purchased with stock of the new corporation, no matter how many years ago, it is necessary to ascertain how much of such stock was issued for the tangible property and how much of such stock was issued for the intangible property, since the latter may not exceed the statutory limit. Any evidence which the taxpayer can submit to show this fact will be received by the Treasury Department. When the taxpayer satisfactorily proves the actual cash value of the tangible property at the time of the purchase, it will be assumed that stock in that amount of par value was issued for the tangible property and that all the remaining stock was issued for the good will, but unless the taxpayer satisfactorily proves the value of the tangible property, the presumption will be that all of the stock was issued for the good will and intangible property, and the invested capital will be reduced accordingly. Where the Commissioner is unable to satisfactorily determine the respective amounts of stock issued for the different classes of property, the tax will be assessed by comparison with similar corporations. This paragraph applies to the case of a business reorganized after March 3, 1917, only in connection with the special provisions applicable to such reorganization, which are discussed in a subsequent paragraph.

50. **Appreciation and Depreciation.** As has been stated, property paid in as capital is valued at the time it is paid in. Therefore the invested capital cannot be increased by the appreciation in the value of property, even though established by expert appraisal or indisputable evidence of value. If property has at any time been marked up on the books because of such increase in value, the capital and surplus as shown

by the books must be reduced to eliminate such appreciation. On the other hand, if property has decreased in value because of physical exhaustion or obsolescence, the Regulations require recognition of such diminished value in connection with determining the surplus. In other words, the surplus shown by the books does not in fact represent the accumulated gain unless it has been charged with the loss actually accrued by reason of the diminishing value of property, and with all other losses. However, if there is no surplus, such losses need not be applied against the paid-in capital or the paid-in surplus, for which full credit is given, although the amounts may to some extent have disappeared from the assets of the company because of losses.

51. **Changes in Capital During the Year.** The invested capital used in this connection is the average invested capital for the taxable year or for the prewar period. Therefore, after having made the necessary adjustments in the capital as of the first day of the taxable year, it is necessary to show the changes subsequently occurring. The average for the prewar period is found after each year has been separately treated, following all requirements applying to the taxable year. As already stated, nothing can be added on account of any addition made to the surplus or undivided profits from profits earned during the year in question. If new stock is issued for cash or property, this amount should be shown as an addition to the invested capital. If any stock is retired, the invested capital must be correspondingly reduced. If the federal income tax for 1917, paid in July, 1918, exceeded the 1918 profits earned to that date, the surplus must be reduced on this account. All changes must be computed as an average for the year; in other words, if new capital is paid in on April 1, and is in the business for only three quarters of the year, the invested capital is not increased by the full amount, but only by three-quarters of it. New capital of $50,000 paid in on January 15 increases the invested capital by $50,000 for 11½ months or $47,916.67 for 12 months.

52. **Reduction of Invested Capital by Dividends.** Dividends paid must be deducted from the invested capital where paid from the surplus or undivided profits on hand at the beginning of the year, and dividends paid during the first sixty days of the year are deemed to have been paid from such previously accumulated profits. Dividends subsequently paid are deemed to distribute the current profits, to the extent that they are sufficient. The profits earned after the beginning of the taxable year and before the date of payment of the dividend should be ascertained, and if such profits are sufficient to cover the dividend, no reduction of the invested capital should be made. If the books of the corporation do not show the profits earned up to the date of payment of the dividend, the earnings shown by the books for any accounting period in which the dividend was paid must be divided ratably over the period. For example, suppose that a corporation paid a dividend of $10,000 on February 15 and another of $40,000 on April 15, 1919. Suppose, also, that its books did not show the amount of profits earned between January 1, 1919, and April 15, 1919, but did show that $60,000 was earned between January 1 and June 30, 1919. In this case, it will be held that seven-twelfths or $35,000 of the $60,000 was earned before April 15

and that all of the first dividend and $5,000 of the second dividend was paid from the previously accumulated surplus. The invested capital must therefore be reduced by deducting $10,000 for 10½ months, or $8,750, and $5,000 for 8½ months, or $3,541.67, a total deduction of $12,291.66. This result apparently will not be affected by any showing short of a book profit, even though the volume of sales or other facts may indicate that the whole $60,000 was earned before February 15 and that the business after that date was unprofitable. Probably the same rule will apply to determine the current profits up to a given date in connection with other payments.

53. **Inadmissible Assets.** The invested capital must be reduced to the extent that any part of it is invested during the taxable year in assets (other than obligations of the United States) which produce an income which is exempt from the tax. Such inadmissible assets consist of stocks in domestic corporations, securities issued under the Federal Farm Loan Act, State and Municipal bonds, and similar tax exempt securities, but do not include any bonds of the United States Government nor any tax-free covenant bonds. Where such exempt securities are carried with borrowed money, the interest upon which may not be deducted from the gross income because of the limitation discussed in par. 157, there may be excluded from the inadmissible assets the same proportion of the total investment as the disallowed interest bears to the exempt income, since the income is thus in effect included in the taxable net income. Similarly, where the taxable net income includes gains or profits derived from selling or otherwise dealing in such securities, the investment in inadmissible assets may be reduced to the same proportion of the actual investment which the exempt income derived from such assets during the taxable year bears to the entire net income derived therefrom, including the exempt income and the taxable profits. To illustrate: The Hawley Chair Company buys two bonds of the Morse County Drainage District for $1,800, carying them in part with a loan of $1,000 at 7%. It holds the bonds for six months; during this time it receives an interest payment of $60 and pays $35 interest on the loan; it then sells them at a profit of $125. In this case the exempt interest is in fact only $25, five-twelfths of the total interest, representing an investment of $750. As the exempt income is only one-sixth of the total income, including the $125 profit, only one-sixth of $750, or $125, is deemed invested in inadmissible assets.

54. **The Deduction for Inadmissible Assets.** After the amount of the investment in inadmissible assets has been determined in the manner stated, it must be reduced to the basis of an average for the year, by the same method used for changes in the invested capital. The average amount of total assets, admissible and inadmissible, held during the taxable year, also must be thus ascertained. The average invested capital must then be reduced by the percentage found for the average inadmissible assets as compared with the average total assets. To illustrate by the case of the Hawley Chair Company above: The inadmissible assets amount to $125 for six months, or $62.50 for the year. Assuming that the average total assets of the company, not the net assets, were $100,000

for the year and that the average invested capital was $42,000, the invested capital must be reduced by .0625%, or $26.25, making the invested capital, as adjusted, $41,973.75.

55. **Invested Capital of Reorganized Business.** In any case of reorganization, consolidation, or change of ownership after March 3, 1917, of a business or of property, where any of the same persons previously interested in or controlling the property or the business retain an interest or control amounting to 50% or more, the new corporation is not allowed to compute its invested capital the same as if the business had been sold to strangers, but the property received from the previous owner must be valued as follows: If the previous owner was a corporation, no asset received from it shall be included in the invested capital at any greater value than would have been allowed to it as invested capital of the prior corporation. If the previous owner was an individual or partnership, all assets transferred must be valued at their cost when acquired by such previous owner, with allowance for all depreciation, impairment, betterment or development, but with no addition on account of expenditures deducted at any time in computing taxable net income. The purpose of this restriction is to prevent any advantage to those who have reorganized their business after the passage of the first Excess Profits Tax Law. To illustrate: Frank Walsh was operating a department store representing an actual investment of $70,000, but actually worth $100,000, because of the development of its good will and the increase in the value of its real estate. As he needed more capital, he organized a corporation which took over the business on July 1, 1917, for $100,000 in stock which was issued to Walsh. George Ridgely and Daniel McKay each invested $40,000 in cash and received $40,000 in stock. The invested capital of the new company will be $150,000, although it would have been $180,000 if the same transaction had been carried out in January, 1917, or if Ridgely and McKay had taken a greater amount of stock than Walsh, or had bought out Walsh for cash. The computation of prewar income of a reorganized business has already been discussed at par. 25.

PART 3. DETERMINATION OF NET INCOME.

56. **Nature of Income.** The law defines income to include "gains, profits, and income derived from salaries, wages, or compensation for personal services * * * or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property * * * also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever." Income represents gains or additions to wealth and does not include moneys received in return for, or in exchange for, wealth already owned in a different form. For instance, if a man receives $100 in payment of a note which he has held as security for money loaned, such payment is not income because he already was worth the value of the note. But if he receives $6 as one year's interest on that note, that is income because it is what his investment earned for him.

57. **Gross Income and Net Income.** All that a person receives in the way of gains or profits, with certain exceptions described by the Act, makes up the "Gross Income," which therefore means taxable gross income. The entire salary received or the entire sales of a business would be the Gross Income. The Act then specifies certain "Deductions" which are allowed, such as business expenses, losses, depreciation, etc., and the remainder is what is called the "Net Income." The Net Income must be determined in accordance with the instructions on the Return and by showing the total Gross Income and several Deductions. The various exemptions and credits, such as the $2,000 personal exemption, are then deducted from the Net Income in computing the tax. The Returns are revised from time to time and the reader should study this Guide in connection with the latest form of Return. The principles stated herein, except where qualification is made, are applicable to all persons, including corporations and partnerships.

58. **Calendar and Fiscal Year.** Net Income is to be determined for the calendar year unless the taxpayer regularly employs books based upon an annual accounting period ending upon the last day of some month other than December. If such books are kept, the taxpayer, whether individual, partnership, or corporation, must make the Return in accordance with such accounting period, which is called the fiscal year. Apparently a concern which actually makes an annual closing of its books on a fiscal year basis is no longer allowed to choose, as formerly, whether to report on this basis or for the calendar year. A fiscal year must cover a twelve month period ending on the last day of a calendar month, and an accounting period of any other length or not ending on the last day of some month will not be recognized. The Return may sometimes cover less than twelve months, as where it is the first Return filed or where the fiscal year is changed, but in no case will a Return for more than twelve months be allowed. To change from calendar year basis to fiscal year basis, or from one fiscal year to another or to the calendar year, permission must be secured and a Return must be made for the portion of a year intervening between the end of the old and the end of the new annual period. Where the Commissioner finds that a taxpayer intends to do any act prejudicing the collection of the tax, such as concealing his property or leaving the country, he may declare the taxable year terminated and require a Return.

59. **Receipt and Accrual Computation.** There are two general methods for computing income, known as the Receipt Basis and the Accrual Basis. The first implies that only the amounts actually received and disbursed during the year shall be included, while the second recognizes credits and charges which have been incurred, even though they have not been paid or even though they are not due or payable. For example, if salary is payable on January 15 for the month ending on that day, the amount paid would, on the Receipt Basis, be regarded entirely as income for the year in which payment is made, while on the Accrual Basis only one-half would be reported for that year and one-half would be charged in the prior year when the salary was being earned. The Revenue Act requires the taxpayer to use the Receipt

Basis except where books of account which clearly reflect the income on some other basis are regularly employed. In such a case the Return must be made in accordance with the books of account, apparently without allowing the taxpayer the choice which he formerly had, of using the Receipt Basis instead. The Accrual Basis may be used to a greater or lesser extent; for example, although almost all business accounts include, in the income, sales made but not collected for, and very many charge off during the year only so much of an insurance premium as covers the actual expiration, less frequently taxes and interest are charged on the accrual basis. No particular method of bookkeeping is required, so long as the actual facts are represented. In any event, the income should be computed on the Return in accordance with the books, except where the books fail to show the actual income as required by the law—for instance in the item of amortization which is allowed only within prescribed limitations, or in the matter of anticipations, discussed in the next paragraph.

60. **Anticipations and Reserves.** Both the gross income and the deductions must be computed on the basis of actual results and closed transactions, even under the Accrual Basis, and not upon the basis of prospects for the future. For example, interest charged off must actually relate to the period covered, and it would not be allowable to charge against a very profitable year interest or any other expenses neither accrued nor paid until subsequent years. Nor may a charge actually related to one year be used to reduce the income of a later year, even though it was not entered on the books or on the Return in the proper year. Thus a reserve set up for a contemplated advertising campaign cannot be treated as an accrued expense. A reserve for possible fire loss, shrinkage in value of inventory, or the estimated proportion of uncollectible accounts, does not represent any loss actually sustained and cannot be deducted. Where such reserves are set up, the expenses and losses may be deducted when they actually accrue and are charged to the reserve. Similarly a profit is not taxable until it is realized, and the gross income should not include the apparent gain resulting from an appraisal of plant or property at an increased value, an increase in the market price of inventoried merchandise, an advance in the current price of listed securities held, or any other source of purely "paper profit." In general, income should include all gain or loss actually sustained by a closed transaction, and for this purpose there is a closed transaction whenever there arises an obligation to pay a fixed sum or whenever property is taken as payment of a fixed sum. Thus the exchange of real estate or securities at agreed values, the sale of property for notes, the issue of stock with a par value, or the valid release or compromise of indebtedness, would constitute a closed transaction which should be reflected in the computation of income.

61. **Constructive Receipt.** The Receipt Basis is not limited to receipt in cash but includes payment made in a substitute for money, and credits available or appropriated. Thus, even on the Receipt Basis, income must include interest and rents paid with notes or securities, professional fees paid in real estate, wages paid partly by furnishing

board and lodging, partnership profits ascertained and credited to the partners, salaries or dividends credited to a drawing account, and all income for which the recipient accepts an act or obligation as payment, or which is held subject to demand. There is no constructive receipt where the payment does not represent a fixed sum; for example, rent based upon crop shares is not regarded as income until the crops received have been reduced to money.

(A) Items Not Included in Gross Income.

62. **Nature of Excluded Items.** As the term "gross income" is used only to refer to taxable gross income, it does not include gains which are exempt, because of specific provisions of the statute or because they accrued prior to March 1, 1913, when the first income tax law went into effect. The gross income also does not include amounts received which represent a change in form rather than an addition to wealth and which therefore are not gain.

63. **Gifts.** The value of property acquired by gift, bequest, devise, or descent is not included in income of individuals or corporations, but the income from such property must be included. A man who inherits a farm does not include the value of the farm, but all rents or other income received must be included. Where a will makes a gift of the income from an estate during a specified period to persons who are not the devisees of the principal of the estate, such persons are not taxed upon the amounts received. The voluntary release of a debt owing by a corporation is a gift to that corporation and does not add to its gross income.

64. **Compensation for Personal Injuries.** Amounts received by an individual as compensation for personal injuries or sickness are not regarded as gains and are not included in the gross income. This applies to payments made under accident insurance policies, health insurance policies, workmen's compensation acts, judgments for damages for such injuries, and settlement or compromise agreements.

65. **Damages for Injuries to Rights or Property.** Damages recovered in any manner because of injury to property, interference with rights, or breach of contract, are not income because in the usual case they merely take the place of wealth or capital without adding thereto. It is, however, possible that the destruction of property may result in a money compensation which amounts to more than its cost (or value on March 1, 1913), or that the expected profit upon a contract may be actually realized by recovering for the breach. In a case of this kind the gain will be held taxable. Special provision has been made by Regulation for allowing the replacement of property requisitioned for war use or lost, destroyed, or damaged through war hazards at an advanced cost without incurring any tax on the difference between the cost and the amount received as compensation, if the entire amount received is actually used for replacement with similar property. If placed in a replacement fund, established by special permission in each case, the accounting may be deferred for a reasonable time until replacement is practicable.

66. **Proceeds of Life Insurance Policies.** The money received upon a life insurance policy by the estate of the insured or by an individual beneficiary, at the death of the one insured, is not taxable. Proceeds of life insurance policies paid to corporations or partnerships are taxable as profit to the extent that the amount received exceeds the premiums paid and not deducted as an expense in any Return of income. Where upon the maturity of an endowment policy or upon the surrender of a life insurance policy for cash, payment is made to the insured or some other person who has been paying the premiums, all that is received in excess of the amounts paid is income. Annuities are subject to the same rule. Dividends on life insurance policies that have not matured are not income, but dividends on matured policies are income, taxed just like dividends on corporation stock.

67. **Alimony.** An amount received as alimony or separation allowance under a decree of court or a separation agreement is not to be included in the gross income of the recipient, nor may it be deducted by the person who pays it.

68. **Dividends Received by Corporations.** The amounts received by a corporation as dividends upon stock in other taxable corporations, formerly included in the net income, but credited for certain taxes, are now exempted from all taxes and are not included in the taxable net income. Although the law provides that such dividends shall be included first in the gross income and then again in the Deductions from gross income, it appears more logical merely to exclude the dividends from the gross income, and as this may be required by the Return the point is mentioned here. Dividends received by individuals are taxed (see par. 116).

69. **Compensation of State Employees.** The compensation of all the officers and employees of a state, or political subdivision thereof, are exempt from tax and need not be included in gross income. This exemption does not extend to federal employees, but mail clerks, postmasters, revenue collectors and other United States employees are taxed upon their salaried incomes. Pensions paid by the United States Government are not exempt.

70. **Compensation in Army and Navy.** Gross income does not include so much of the salary or compensation received during the present war for active service in the military or naval forces of the United States as does not exceed $3,500. Otherwise, compensation of persons in the army or navy is subject to tax. This exemption does not apply to pensions or to government allowances to families of soldiers or sailors, which are taxed, but an allotment from exempt compensation will also be exempt.

71. **Income from Gold Mining and Sale of Oil Wells and Mines.** The net income derived from the mining of gold by a corporation is exempt from the Profits Tax, and the profit made by selling mines, oil wells, gas wells, or any interest therein, where the principal value results from prospecting, exploration or discovery work done by the taxpayer, is subject only to a limited Profits Tax in case of a corporation and Surtax in case of an individual, which shall not exceed 20% of the selling price.

72. **Interest on United States Bonds.** The law exempts the interest upon obligations of the United States issued before September 1, 1917, and upon those issued after that date, if and to the extent provided in the act authorizing the issue. Where such interest is wholly exempt it is not included in the gross income, but if any of the interest is only partially exempt that much of it must be included in the gross income and net income and then shown in the proper credit (see par. 8). United States bonds of the First Liberty Loan and all prior issues are wholly tax exempt. All subsequent issues are wholly exempt as to the individual Normal Tax and the corporation Income Tax, and the Surtax upon individuals and the Profits Tax upon corporations do not apply except to the interest upon more than $5,000 of principal in one ownership of an aggregate of Liberty 4% and 4¼% Bonds of the Second, Third and Fourth Loans or First Loan converted, War Savings Stamps and Certificates of Indebtedness. For two years after the war there is a further exemption from these taxes covering the interest upon additional obligations not in excess of the following amounts of principal in one ownership: $30,000 of Fourth 4¼'s; $30,000 of First 3½'s, converted to 4¼'s of the issue of October 24, 1918; Second and Third or First or Second converted 4's and 4¼'s, in the aggregate not exceeding $45,000 nor one and one-half times the amount of Fourth 4¼'s originally subscribed to by the taxpayer and still owned at the date of making the Return. For example, a corporation holding during 1919 $10,000 of Third Liberty Loan Bonds and $5,000 of the Fourth Loan, originally subscribed for, is not taxed upon any of the interest received but the interest upon $10,000 of the same bonds received more than two years after the end of the war, as proclaimed by the President after the consummation of the peace treaties, will be subject to the Profits Tax.

73. **Income from State and Municipal Securities.** Gross income does not include interest from bonds or other obligations of the states or political subdivisions of a state. Corporations as well as individuals receive the benefit of this exemption. The term "political subdivision" includes any special assessment district or division created by the proper authority of a state, acting within its constitutional powers, for the purpose of carrying out some public work which is a function of the State Government. This includes drainage districts, school districts, highway districts, etc.

74. **Bonds of Public Utility Corporations.** The above exemption extends only to income derived from obligations of political subdivisions of the states, and not to the income derived from securities of private corporations conducting waterworks, irrigation projects, railroads, street railways, telephones, light plants, or other utilities. Also, when a municipality purchases a public utility subject to a mortgage, the mortgage retains its original character, even though the municipality pays the interest thereon.

75. **Bonds of Foreign Governments.** Interest from bonds of foreign governments is not exempt. Therefore, coupons from English, French, Canadian, Argentine, Chinese or other foreign government bonds must be included in gross income.

76. **Federal Farm Loan Act Securities.** The Federal Farm Loan Act, as well as the Income Tax Act, provides that the securities issued under that act shall be exempt from the Income Tax. The same is true of dividends received from Federal Reserve Bank Stock. These securities are not, however, obligations of the United States and do not share in other exemptions, such as the privilege of being included in invested capital, which are conferred upon government securities.

77. **Bonds of War Finance Corporation.** Interest upon bonds issued by the War Finance Corporation is exempt if and to the extent provided in the respective Acts authorizing the issue thereof.

(B) Particular Items of Gross Income.

1 Salaries, Wages, Commissions, Fees, Etc.

78. **Compensation Is Income.** All forms of compensation for personal services are income. The full amount received must be shown as gross income and any direct expenses which are allowable are shown as Deductions from gross income. No deduction can be made for the cost of training or education, cost of living, or other indirect cost which may be involved in maintaining the ability to render the services. Salaries, commissions, professional fees, and other forms of compensation are regarded as income when received, regardless of when they were earned, unless they are accrued as income on books regularly kept by the taxpayer. An agent on commission who receives in January, 1918, a large amount in settlement of the commissions earned during 1917, must pay the 1918 tax on that amount, although his business transacted in 1918 may actually be so small that he has not earned any taxable net income on that year's business. The compensation of an executor or trustee should be included in the Return for the year when it is received, even though the services may have been entirely performed in other years. Where professional services are billed in one year and entered as income in the accounts, they must be reported as income in that year, even though not collected until later. (For exempt salaries, see pars. 69-70.)

79. **Incidental Benefits.** Living quarters, board and lodging, rent, or expenses, allowed in lieu of salary, must be accounted for as income. Where the compensation for services is paid in part by furnishing a place to live, food, clothes, or any form of valuable goods, the value of such benefits furnished should be estimated in money and included in income. When employees receive incidental benefits from their employment, as for example, free rent, fuel, automobile use, free passes, etc., these constitute taxable income whenever they are in fact part of the employment contract and some value is attached to them. This does not include special expenses incurred in connection with the business and repaid by the employer. For example, a minister receiving a salary of $1,500 per year is supplied with a furnished parsonage with a rental value of $900 per year. His gross income is $2,400. He is sent by his congregation to attend a convention in a distant city, and receives his railroad fare, hotel bill, and expenses. These latter sums are not income. A commission deducted from the premium and retained by a life insur-

ance agent for writing a policy on his own life is income accruing to the agent. Where the incidental benefit is received not as compensation for services, but because of the ownership of a business or of property, it is not income. Thus a farmer is not taxed on the value of farm produce consumed in the family and a taxpayer living in a home which he owns is not taxed on the rental value.

80. **Pensions and Pension Funds.** The taxable income includes amounts received by a retired worker as a pension from a former employer, since this is additional payment for the prior services. Deductions from salaries or wages made by the employer to cover compulsory or voluntary contributions to pension, health benefit, or insurance funds should be added to the amounts received in reporting income subject to tax, but the same amount may be deducted from the amounts subsequently received.

81. **Indefinite Amount.** Compensation is none the less income where the amount is not fixed, but is settled arbitrarily. The clergyman who officiates at a wedding or funeral receives only what is offered to him. His fees are none the less income and must be included in the Return. Where a congregation takes up a subscription to supply its minister with clothes, furniture, or a vacation, it must be determined in the particular case whether it is a donation, which is not income, or whether the compensation is otherwise indefinite in amount and is supplemented by such payments, making them income.

82. **Gratuities and Tips.** Where a tip actually represents compensation for services, it is income of the person receiving it, notwithstanding that the amount is optional to the giver. This includes tips of waiters, bell boys, Pullman porters, and others who are customarily paid for their services in this way. Where tips are not a general practice they are a donation and do not purport to be a compensation. Gratuities not in the form of money, such as cigars, candy or other presents, are not income in any case, as they are not taken as representing money.

83. **Bonuses.** Profit-sharing or bonus or other special form of compensation is income, if it is in fact a payment for services, but not if it is a gift. It is often difficult to ascertain whether sums paid by an employer in addition to the stated compensation are donations, or gifts, or whether they are rewards for specially productive services, or whether they are merely a part of a salary which is contingent in amount. If the payment is given in return for services, it is income to the employee. If it is a gift, it is not taxable income. Circumstances indicate whether it is regarded by employer and employee as gift or compensation, reasonableness in amount being ordinarily the controlling circumstance. (See par. 147.) Christmas gifts, even though customarily and regularly made, are not taxable income.

84. **Ostensible Salaries.** If an amount paid ostensibly as a salary is in fact something different, such as payment for property or payment of dividends, such amount should be reported as the kind of income which it in fact is, rather than as a salary. For example, the owners of all the stock of a corporation may agree to divide all the profits under the name of salaries. In this case, the individuals would be subject

only to the surtax upon the amounts paid, because they are in fact dividends, and not to the normal tax which would apply if they were in fact salaries. In general, the income should not be reported as a salary unless it is an allowable deduction under that description, which is described more fully in par. 146.

2. Trades, Businesses, Commerce.

85. **Mercantile or Manufacturing Business.** The gross income of the usual business will consist of the gross actual sales, together with income received from other sources. Allowances, discounts and similar credits given to purchasers should not be reported as deductions on the Return, but should be excluded in computing gross income, so that the Return will show what was actually received in the business during the year. Technically only the gross profit is income, rather than the total selling price, but purchases and inventories are not expressly classified by the Act, and are treated on the Returns and in this Guide as Deductions from gross income, together with cost of manufacturing, expenses, losses and other deductions.

86. **Installment Business.** Installment sales require special consideration, and are governed by special regulations of the Treasury Department which apply without regard to the method of accounting used by the taxpayer. Where a different method has been used in the Return for former years, care must be taken so that the same amount will not be taxed twice nor twice deducted. The requirements differ for personal property and real property.

87. **Chattels Sold on Installments.** In the sale of books, furniture, clothing or like property on deferred payments, the whole profit is apportioned to all of the installments and is reported as collected. The seller need not include the whole profit as soon as the contract is made and is not allowed to collect the entire cost before reporting any profit. For example, the Progress Piano Company sells for $150 a piano costing $50. It receives $10 down and $5 a month. Its tax Return should include in the gross income two-thirds of the year's total collections. There will of course be no additional deduction for purchases or inventories under this plan. Salesmen's commissions, overhead, and similar expenses should be included in the Deductions for the year in which they are incurred.

88. **Real Estate Sold on Installments.** Real estate sales conveying title are distinguished from sales when title is retained, according to the Regulations. This, however, is so much a matter of form rather than substance that the distinction may be abandoned by the Treasury Department. Where the title passes to the purchaser at the time of sale, the seller must include in his gross income the entire profit, including amounts paid in notes or deferred under the contract, whether secured by mortgage or not. If the title remains in the seller, the profit should not be reported until the price is collected; as with personal property each collection consists of a proportion of profit and a proportion of return of capital.

89. **Illustration.** The Webster Development Company sells two tracts of land in March, 1918. The first tract was purchased in 1914 for $30,000 and is sold in April, 1918, for $60,000, of which $20,000 is paid in cash and the balance in notes of $5,000 each, secured by mortgage and due in September, 1918, and each six months thereafter. Title passes at once to the purchaser, with mortgage back. The company is taxed in 1918 on the entire profit of $30,000, although the books of the company treat the first payments as a return of cost and do not show any profit until the payment of the third note. The second tract also cost $30,000 and is also sold for $60,000, with $20,000 paid down. The company does not give a deed in this case, however, but the contract provides for a deed when the full price has been paid and provides for payments of $5,000 every six months, for which notes are taken. Because title is reserved, the taxable income for 1918 will not show the whole profit but, as the profit is one-half of the contract price, one-half of each collection will be shown as taxable income, $10,000 in March and $2,500 in September, 1918. Each year another $5,000 will be reported if two $5,000 payments are collected. This is required even though the company's books in this case also show no profit until after the collection of $30,000.

90. **Real Estate Subdivisions.** Where a tract of land is divided into lots or parcels for resale, the entire cost should be divided among all the parcels and each sale should be treated as a separate transaction, with the proper gain or loss on each sale included in the income reported for taxation. Parts retained by the subdividers or conveyed in payment of expenses must be charged with the proportionate cost and the outside sales can not be applied against the entire cost before computing profit.

91. **Adjustment for Non-Payment.** Where the entire contract profit has been reported as taxable income, the default of the purchaser will give occasion for the deduction of the unpaid amount as a bad debt, if it is actually uncollectible. If part only of the profit has been reported, the entire loss is not deductible, but only so much as represents unreturned cost. Uncollected profit, having never been treated as income, can not be treated as loss.

92. **Property Repossessed.** Where the vendor repossesses real or personal property he is not allowed to charge any loss but must report, as a profit then realized, the amount previously received and treated as return of cost. For example, in the second transaction of the Webster Development Company, if there was a cancellation for default after $40,000 had been paid and the company secured the land again, $20,000 of the $40,000, which has been treated as a return of cost, must now be shown as income and there is no loss. In the case of personal property there may be physical deterioration or other loss in value which should be allowed. The Regulations suggest a charge for depreciation, but as this is not always adequate, the vendor should be allowed to charge off as a loss all of the unreturned cost and to show as income the fair value of the property as recovered, or else to show as income only so much of the cost previously collected as exceeds the loss in actual value of the property.

93. **Contracting Business.** The income of a contracting business can not readily be ascertained at the time the profit is received, where the

work extends over a period of years during which payments are received. The taxpayer is therefore allowed to compute the net income on the basis of completed contracts, reporting the net profit upon jobs completed during the year. The gross income will include the total amount payable for each of such jobs, whether paid in prior years or not collected until a subsequent year, and the deductions will include all allowable charges on account of such jobs in whatever year incurred, but none of the charges incurred during the year for uncompleted contracts. Another method which may be used, at the option of the taxpayer, is to include in the gross income an estimated percentage of the contract price and deduct all of the cost and expense incurred during the year. Thus, if the expense for the year is estimated at 20% of the total expense which will probably be required, 20% of the total contract price should be reported as gross income for the year without regard to the amounts actually received. If the taxpayer does not choose one of these special methods, the income will be computed in the ordinary way in accordance with the regulations and the books of account.

94. **Farming.** When farm products are sold, the entire receipts are gross income and the Deductions include the items of cost and expense. Where the crop is of such a character that it requires more than a year to produce, the deductions may be made upon the crop basis; otherwise the deductions must be reported for the year in which they are paid or accrued. Farmers are allowed to compute net income on an inventory and book basis where an approved method of accounting is followed. Otherwise the return must be made on the basis of receipts and disbursements, notwithstanding that in some cases the cost and expense in connection with a crop is largely or entirely incurred in the year prior to that in which the crop is sold. A farmer need not include in his gross income the value of the farmhouse occupied by his family or the farm produce consumed, but where produce is exchanged for merchandise, groceries or mill products for personal consumption or of permanent value, the fair market value of the article received is income just as if the produce were sold for that amount. A person operating a farm for pleasure or recreation and not on a commercial basis should include in his gross income only the excess of receipts over expenses, instead of the gross receipts, since the expenses are not otherwise deductible, not having been incurred in his business.

95. **Life Insurance Companies.** The gross income of a life insurance company does not include the total receipts from premiums, but there is excluded the amount of any premium received from any individual policy holder which is paid back or credited as an abatement of premium within the taxable year. There are also allowed as deductions the amounts required by law to be added to reserve and the amounts paid upon policies.

96. **Income from Government Contracts.** Many of the relief provisions of the Profits Tax Law are not extended to corporations receiving more than a specified proportion of their income from Government contracts. The law defines a Government contract to be a contract made for the benefit of the United States with any department, bureau, officer, commission, board, agency, or contractor of or for the United

States. Reference to such contracts made between April 6, 1917, and November 11, 1918, includes both dates and includes all contracts entered into during that period which, although originally not enforceable, have been subsequently validated or made enforceable.

5 Sales of Property.

97. **Profit Is Income.** Where there is a sale or other disposition of property which has been held as capital or principal, the entire price is not income but only the profit, which is the difference between cost and selling price. If any part of the profit accrued before March 1, 1913, when the first income tax law went into effect, it is not taxable. Taxable profit is income of the year in which it is realized, notwithstanding that it may have actually accrued in other years. There are, however, indications in the language used by the United States Supreme Court, in cases dealing with the laws of 1909 and 1913, that an income tax law can not lawfully apply to increases in value which occur prior to the effective date of the law, even though realized after that date. On this theory, the profit realized in 1918 would be taxed at the rates in effect when it accrued, but the present law expressly requires the other practice and may not be governed by the cases mentioned.

98. **Realized Profit.** A paper profit or merely a bookkeeping gain, not actually realized in money or otherwise "cashed in," is not income. Suppose stocks, selling on the exchange, are bought at 56 and at the end of the year are selling at 96; in business talk, the fortunate purchaser has made a profit of 40 points, but as he has not yet sold the stock this profit may be increased or decreased before it is finally realized, and the result may ultimately be such a decline that the profit is entirely lost. Therefore, until there has actually been a conclusion of the transaction, there has been no realized profit and no income tax is imposed. On the same principle, the Return should not include as gain or profit any increase in value or any other book gain based upon appraisal or market value, but not actually realized.

99. **Profit Accrued Before March 1, 1913.** A profit accrued before March 1, 1913, that is, before income was taxable, is not taxable even though it was realized after that date. The fair market value as of March 1, 1913, is deducted from the selling price of property purchased before that date to determine the profit. Suppose that, in 1909, suburban real estate was bought for $8,500. During the next two or three years the neighborhood develops very rapidly, so that in 1912 the property is worth $12,500 and similar pieces are sold for that price. In 1918 the land in question is sold for $15,000. There is a profit of $6,500, which is all realized in 1918; but it is expressly provided in the law that in the case of property acquired before March 1, 1913, the amount of gain shall be determined upon the basis of the fair market price or value as of March 1, 1913. In the transaction described, therefore, the taxable profit is only $2,500, which is income for the year 1918. In the same way, if there is a dissolution of a corporation, and the stockholders receive much more in return than they originally invested, their taxable

incomes should include only that part of their gain which remains after deducting from the amount received, the fair value of their stock on March 1, 1913.

100. **Determination of Value on March 1, 1913.** The Return must state how the fair value as of March 1, 1913, is determined. Where there is an established market value, as for stocks traded in upon an exchange, the quoted prices would ordinarily represent the fair value. In the case of real estate, machinery, merchandise, or other property which does not have a public market price, any relevant evidence may be considered, such as the opinions of experts, prices asked or offered for similar property at that time, or other facts. In every case, this is a question of fact to be reasonably and adequately established by the taxpayer. The estimated value should not include any prospective or speculative profits but should represent the price at which the property could have been sold under all conditions then existing.

101. **Cost of Property.** The cost of property, as used to determine profit, may be the inventory value, where inventories are made in accordance with the Regulations. Cost will include, in addition to the original purchase price, expense incident to the procurement, holding, and disposition (provided that such expense has not been charged as a deduction from income), and must be reduced by amounts charged against income of any year for depreciation or depletion. Where depreciation has been charged off, the entire amount charged must be deducted from original cost, because it represents actual receipts which were treated not as income but as return of cost. In buying real estate it is necessary to pay brokers' commissions, lawyers' fees, stamp taxes, recording fees, etc., which are properly considered part of the cost and should be deducted from the selling price in ascertaining profit. Like expenditures in connection with the sale may also be deducted. The rule is the same where personal property is bought and sold at a profit. Carrying charges, such as storage for grain, taxes for unoccupied real estate, interest on stock bought on margin, and insurance, if incident to a buying and selling transaction rather than a general expense, may also be applied against the profit. In the same manner, if the property has been bettered or improved, as when a house is repainted, grain is cleaned, animals are fattened, or an automobile is overhauled (in order to sell for a higher price), the expense of such improvement may be added to the cost. If the expenditure is for the temporary benefit of the owner, who expects to use and enjoy the improvement rather than to pass it on with the property, it is a personal or business expense and not a part of cost. Of course, if any of these items are deducted from gross income when the expenditure is made, they can not later be considered in arriving at profit, even though the deduction may have been improperly made. (See par. 134.) They can not be included as a part of the general expense, and also as part of the cost of property.

102. **Selling Price.** The selling price includes promissory notes, securities, or anything accepted as cash. Except where the special regulations for installment sales apply (see pars. 86-88), notes, mortgages, and other deferred payments must be treated as if the entire price was paid in cash, for the purpose of ascertaining profit, and must be included as

income. In case any installments should be unpaid or any notes should prove worthless, that amount may be deducted from income in a subsequent year, when such losses occur and are charged off as bad debts. The sale of the property is regarded as a closed transaction and the collection of the notes as a new item.

103. **Property Exchanged.** When property is exchanged for other property with a definite or ascertainable fair market value, or where it is valued by the parties at a fair amount for the purposes of the exchange, such value must be treated as the price received for the property originally held to determine profit or loss upon the exchange, and the same amount is the cost of the new property in connection with a later sale. If there is no valuation or market value, there is no closed transaction and the cost of the original property must be treated as the cost of the property acquired. Special provision is made by the statute for the exchange of stock or securities in connection with the reorganization, merger, or consolidation of a corporation. (See par. 110.)

104. **Sale of a Gift.** A man inherits real estate in 1914 which is fairly worth $60,000 and is valued at that amount in the accounts of the probate court. In 1917 the property is sold at a clear gain of $10,000 over all expenses. This gain is taxable, as it represents the income from property received as a gift and not a gift itself. The taxable gain is the excess of the selling price over the fair value as of March 1, 1913, or when acquired.

105. **Stocks and Securities.** Profit from sales of stocks and securities is income. Where stocks or other securities are sold for more than their cost, including the expenses of purchase and sale, the difference is profit and is taxable as income. Regardless of how long the stock has been held, the entire profit is income in the year in which it was received, except to the extent that the profit was earned prior to March 1, 1913.

106. **In and Out of the Market.** It is difficult to ascertain the amount of profit, not only with reference to the income tax law, but even as a practical matter, in the case of the person who is "in and out" of the stock market on a single stock or on a number of stocks. For example, Walter Hinman buys 500 shares of Airplane preferred at 60 in January, 1,000 in February at 65, sells 750 in March at 70, buys 1,000 more in May at 66, sells again in June 750 at 69, and again in July sells 500 at 71. He still has 500 shares. The Treasury Department requires that wherever possible the shares be identified by certificate number, and the exact profit for the particular certificate accounted for. Frequently, this is not possible; for instance, Hinman may have had a single certificate issued in February for his 1,500 shares, or again in May for his 1,750 shares. We do know that he bought, altogether, 2,500 shares and that he sold 2,000. The rule is that the sales must be charged against the stock first purchased in successive order; that is, the cost of the 2,000 shares sold shall be figured at the cost of the first 2,000 bought. The rule assumes that the first stock purchased is the first stock sold. The 500 shares which he has retained are considered as costing the price last paid, this in our illustration being 66. Hinman's profits are therefore $6,000 on the first sale, $2,250 on the second sale, and $2,500 on the last sale.

107. **Profits Upon Different Issues of Stock.** Many people who trade in stocks accept their broker's account of their balance without knowing, after the lapse of time, just which stock made their profit. This does not give sufficient data to make a complete Return. If there is a profit on some stocks and a loss on several others, and the year is closed with a credit balance and also large holdings, which have been in part purchased with profits made in the market, it is obvious that the cash balance alone does not represent the income. The actual gains must be shown, and the prices actually paid for the stocks held at the end of the year must be known, so that income for the next year may be computed. All the profit made in trading in stock, without deduction for losses, should appear as income on the Return. Suppose Hinman buys 2,000 shares of Metal Boat Company stock at $35 a share and at various times during the year sells as follows: 500 shares at $40, 500 at $33, 500 at $30 and 500 at $36. He has lost money, but on the income side of his Return he should account for the $3,000 profit made on the two sales. As with stock, so in the case of any other property, if there is a sale at a profit, income has actually been received and must be accounted for, even though losses may have been suffered upon other sales. Such losses, if allowable, can be deducted only by including them in the Deductions.

108. **Corporation's Treasury Stock.** The original sale of unissued stock of a corporation is a contribution of capital and does not involve profit or loss to the corporation whether the stock is issued at par, at a premium, or at a discount. Where stock once issued is returned to the corporation as a gift or otherwise, to be resold to provide capital, the proceeds are regarded as additional capital and not income. Where a corporation with power to buy and hold its own stock sells such stock at more than its cost, having carried the stock as its property without retiring it, it receives a taxable income. If stock is purchased by a corporation and retired, later issue of stock in place of the cancelled stock is a capital transaction and not a sale.

109. **Property Transferred to a Corporation as Capital.** Frequently property is taken over by a corporation in exchange for its stock, the par value of the stock being sometimes very much more and in other cases very much less than the actual value of the property. Property is also conveyed without consideration or for a nominal consideration. As this is done to provide the capital of the corporation, the valuations used are not the true cost and are not binding in case the property is later sold by the corporation. In that event, the taxable profit is determined upon the basis of the true value of the property when acquired. If this value exceeds the book cost, the excess should be entered on the books as a paid-in surplus. The value for this purpose represents also the price received for the property, upon which gain or loss should be computed, and also the cost of the stock to be used in determining the gain or loss of the stockholder upon the sale of the stock. In the ordinary case the par value of stock issued for property is presumed to be its actual value, and will be treated as the price of the property. Thus where stock of a corporation is issued to the incorporators for the good will of a business being transferred by them to the

new company, the individuals will be subject to income tax upon the amount by which the actual value of the stock received exceeds the value of the good will on March 1, 1913, if it was then in existence as an asset of the business, or its actual cost if subsequently acquired. Any certificates or affidavits filed to show that the stock was fully paid up would, of course, constitute evidence against any claim that the stock was worth less than par.

110. **Stock Received Upon Reorganization or Consolidation.** Where stock or other securities in a reorganized or consolidated company is received in exchange for stock or securities of the old company, this is regarded as a closed transaction analogous to a sale. If the aggregate par or face value of the securities received does not exceed the par or face value of the securities given in exchange, no profit or loss to the owner occurs. If the aggregate par value of the new securities is less than that of the old, there may be a deductible loss equal to the difference between the actual value of the new securities and the cost (or value on March 1, 1913) of the old securities. When the aggregate par or face value of the new securities received in any such reorganization exceeds the aggregate par or face value of the securities exchanged, the excess of par value shall be taxed as a profit, to the extent of the difference between the fair market value of the new securities and the value on March 1, 1913, of the original securities, or their cost if they were subsequently acquired. An equal amount in par or face value of the new securities shall be treated as taking the place of the securities given up, and the entire taxable gain will be regarded as the cost of the remaining securities received. In the absence of a showing to the contrary, the par value or book value of the new stock will be taken as the actual value. Thus a stockholder turning in one share of $100 stock, for which he paid $250 in 1914, in exchange for one share of preferred and two shares of common stock, par value $100 each and total fair market value $320, in a new company organized to take over the business and property of the old company, will be assessed upon a profit of $70. One share of the new stock will be held as at a cost of $250, and the other two will be considered as having cost $35 each.

111. **Effect of Stock Dividend on Cost.** After payment of a stock dividend, the following method of determining cost of the new and the old stock must be used to ascertain profit or loss in case of sale. The cost of the old stock (or its value on March 1, 1913, if previously acquired) is divided by the total number of shares of old and new stock and the result is the cost per share of both the old and the new stock. To illustrate: If ten shares were purchased in 1918 at a cost of $200 per share and a stock dividend of ten shares was received in that year, the twenty shares of old stock and new will be regarded as costing $100 per share.

4. Interest Received.

112. **Received and Accrued.** Unless books are kept on the Accrual Basis, interest is returnable when received, no matter when earned. But interest credited or held subject to call, as savings bank interest

and bond coupons, is constructively received, that is, it must be returned as from due date. Exempt interest has already been discussed.

113. **Interest on Bonds of Exempt Corporations.** The fact that a certain corporation is itself exempt from tax upon its income does not exempt the interest received by taxable persons from it. For example, if a mutual benefit cemetery company or an incorporated social club issues interest-bearing bonds to raise funds, individual owners of such bonds must account for the interest.

114. **Interest on "Tax Free" Bonds.** Exempt securities, such as municipal bonds, should be clearly distinguished from tax free bonds, which are so called because they provide that the interest will be paid "free of all taxes" which the debtor is required to pay upon or withhold from such interest. The interest upon such bonds is fully taxed and an individual owner will include in his income the entire amount of the interest. But the debtor corporation or "source" is required to pay on his behalf a tax of 2% of the interest, and the amount so paid is shown as a credit on the Return of the individual and applied toward the total tax which would otherwise be due. This payment at the source is required only where a corporation agrees to pay the interest on its bonds or other obligations without deduction for any tax which it may be required or permitted to pay thereon or retain therefrom under any law of the United States, or agrees to pay any portion of the federal income tax of the owner of its bonds or other obligations, or reimburse the owner for any portion of such tax. It is not required where a claim for exemption is filed nor where the bonds are owned by a domestic corporation, but such a corporation may have the benefit of the payment where it can show that it was actually made. By analogy to the rule established with reference to bank stock (see par. 126), it would appear that any tax so paid at the source should be reported as additional interest by the holder, but this has not been required.

115. **Accrued Interest on Bonds at Time of Sale.** When a bond is sold between interest dates, the seller and the purchaser apportion the interest becoming payable, and the amount earned up to the date of the sale is paid by the buyer of the bond to the seller. If interest is payable every six months, January 1 and July 1, and the bond is sold on April 1, the buyer will pay the seller one-half of the interest, and that amount shall be included in the seller's Return as interest received and not as part of the profit on the bonds. The buyer should not include the amount so paid in his computation of the cost of the bond, but when he receives the interest payment in July, the entire amount is not income to him, but only that part in excess of what he has paid to the seller, and he will therefore include in his Return only one-half of the interest received by him.

5. Dividends.

116. **Subject Only to Surtax.** The amounts received by an individual as dividends upon the stock of domestic corporations are included in the gross income only for computing the surtax and are not subject to the normal tax. Dividends received by a corporation are not subject to any

Income or Profits Tax. This is on the theory that the dividend is a distribution of income which has been already taxed when earned by the paying corporation. Dividends paid by foreign corporations not paying an income tax to the United States are subject to all taxes.

117. **Defined.** The law defines ''dividend'' to mean any distribution made by a corporation out of its earnings or profits and payable to its shareholders or members in cash or property or stock. The ordinary form of dividend is the periodical cash distribution of the current profits. A dividend may be paid in property, as when Liberty Bonds are so distributed, and it may distribute profits accumulated over a long period. When paid in new stock issued by the paying corporation it is called a stock dividend. When paid in property, dividends should be reported as the actual value or fair market value of the property at the time of the distribution. Dividends must be distinguished from bond interest, which is an expense of the corporation and not a share in its profits. If preferred stock is actually stock and not a certificate of indebtedness under a false name, it can not bear interest but the return is a dividend. The gain realized by a sale of stock or by surrendering it upon the liquidation of the company for more than it cost is not a dividend but a profit which is subject to all taxes.

118. **Profits Earned Prior to March 1, 1913.** If a dividend represents profits earned by the corporation prior to March 1, 1913, there is no tax, since profits then on hand belonged in substance to the shareholders and might have been withdrawn by them without tax. But a dividend can be paid from a surplus then accumulated only after all subsequent profits have been distributed, as the law expressly provides that a dividend paid in 1918 or subsequent years is deemed to have been paid from earnings or profits accrued since February 28, 1913, if any remain undistributed, and such a dividend can not be made non-taxable by declaring that it is paid from the prior surplus or by charging it on the books against such surplus. (See Illustration following).

119. **Taxable as Received.** Taxable dividends, other than stock dividends, are subject to the general rule that income not previously accounted for on the Accrual Basis is taxed as income of the year in which received, and it is not material when the dividend was declared nor when the corporation earned the profits being distributed (provided they were not earned prior to March 1, 1913). It is possible that the law may in this respect be held invalid by the courts, in view of certain decisions of the Supreme Court and the fact that the earnings of a corporation belong in substance to the shareholders as soon as accrued.

120. **Distributions Not from Profits.** A distribution is not a dividend and it is not taxable when it does not constitute a distribution of income of the corporation, as where a corporation reduces the par value of its stock, returning to every shareholder $50 for each $100 paid in, or distributes a paid-in surplus, received originally from the stockholders or a mere book surplus, created by carrying an asset, such as good will, at more than cost. A dividend from depreciation or depletion reserve is in fact a reduction and impairment of capital and should be so shown on the books. The law, however, makes any such non-taxable distribution im-

possible in any case where the corporation has an earned surplus, no matter how the distribution is described by the directors or shown on the books, by providing that "any distribution shall be deemed to have been made from earnings or profits unless all earnings and profits have first been distributed." (See Illustration following). This does not apply to amounts distributed in liquidation of the corporation, which must be treated as payments in exchange for stock, and any excess over cost is expressly taxed as a profit (if not accrued prior to March 1, 1913), even though in fact a large earned surplus may in that way be distributed. In all cases of distributions not from profits, the amount received should be treated as a return of cost or value on March 1, 1913, if previously acquired, and as taxable profit when in excess of such cost or value. When stock is so distributed, the cost of the old and the new stock is found by apportioning among all the shares the cost of the old stock (or its value on March 1, 1913).

121. **Illustration of Taxation of Dividends.** The Essex Investment Company had an earned surplus of $1,000,000 on March 1, 1913. It added $500,000 to the surplus between that date and December 31, 1916, and $300,000 from the operations of 1917. In 1917 the properties of the company were appraised at $1,000,000 more than their book value and were entered on the books at the appraised value as of December 31, 1917, thereby increasing the surplus. At the same time, the good will of the company was entered on the books as an asset at $1,000,000. On January 3, 1918, the directors declared a dividend of $2,000,000 as a distribution of the surplus created by the appraisal and good will entries, and a $200,000 dividend from the 1917 profits. The dividends were payable in cash on January 5, 1918. These dividends will be together considered a distribution of the entire surplus of $800,000 earned since March 1, 1913, and on this amount the shareholders will be taxed at the 1918 rates. The untaxed remainder of the dividend will be first applied against the $1,000,000 surplus earned prior to March 1, 1913, and then against the created surplus, of which $400,000 is distributed. Subsequent dividends paid in 1918 will represent first 1918 profits and any excess over 1918 profits earned at the time of payment will be a further taxfree distribution of the created surplus. Harley Davis owns 100 shares of the stock of the Essex Investment Company and receives $110 per share, or $11,000 upon the dividend described. Only 8/22 of this amount, or $4,000, will be included in his reported income, and on this amount he will pay the 1918 surtaxes, $5,000 or $50 per share is not taxed because it is paid from the profits accumulated prior to March 1, 1913. $2,000 is not taxed because it is not a distribution of profits. He later sells 50 shares of his stock for $10 a share more than the $100 which he originally paid. Since he received $20 a share from the corporation on account of the increase in the value of its good will and other property, he must report a profit of $1,500 or $30 per share on the stock sold. On July 10 he receives a further dividend of $10 a share, upon the remaining 50 shares, and is advised by the corporation that the earnings of the company for the six months and ten days of 1918 are estimated at $100,000, or $5 per share. Harley Davis will therefore report an additional $250 as dividends and the cost of his 50 shares will

be reduced to $75 per share because of the further distribution of the created surplus. As they may ultimately be sold for even less than that, he is not required to report any profit until the shares are disposed of.

122. **Stock Dividends.** The law expressly provides that a stock dividend constitutes income to the amount of the earnings or profits distributed, which will be the valuation at which the stock is charged against surplus, usually the par value. In a recent decision, however, a lower Federal Court has ruled that Congress has no authority to thus tax stock dividends. This is in line with previous decisions of the Supreme Court and the prevailing legal opinion, but the Treasury Department may continue to act in accordance with the language of the statute until it is held unconstitutional by the Supreme Court, which will soon pass upon the question.

123. **Dividends from Personal Service Corporations.** In view of the special plan for the taxation of personal service corporations (see par. 30), the shareholder is not taxed upon a distribution of profit of such a corporation earned after December 31, 1917. Until such exempt profits have been distributed, distributions are deemed to be made therefrom; but after such profits have been exhausted, distributions are deemed to be made from profits accumulated after February 28, 1913, and prior to January 1, 1918, and are taxed at the rates in effect when received.

124. **Profits Unreasonably Accumulated.** If the Treasury Department finds that a corporation is formed or availed of for the purpose of preventing the imposition of the surtax by permitting the income of the corporation to unreasonably accumulate instead of being distributed, the shareholders will be assessed (as in a partnership or personal service corporation) upon the amount to which they would be entitled if the profits were distributed, and the corporation itself will be exempt from Income Tax. The corporation is not exempt from the Profits Tax, as a personal service corporation would be, but the amount of that tax is deducted from the net income upon which the shareholders are assessed. When the Secretary of the Treasury certifies that in his opinion the accumulation of profits is unreasonable for the purposes of the business, that fact or the fact that the corporation is a mere holding company is *prima facie* evidence of a purpose to escape the surtax. Every corporation is required to furnish on request a statement showing the amount of profits accumulated and the names and shares of the persons entitled thereto in case of distribution.

125. **Dividend on Life Insurance Policy.** Life insurance policies commonly have a so-called dividend or earning feature. The dividend is, in fact, a part of the premium which is returned to the policy holder because it was found that the expense, losses, etc., of the company were not in fact as heavy as had been anticipated, so that its year's income provided some excess over its expense and reserve requirements. The dividend is not, therefore, a gain or profit, but merely a discount or refund from a price paid. A life insurance policy dividend is not income when premiums are being paid on the policy, but if the policy is paid up the dividends thereafter are income.

126. **Special Forms of Dividends.** Private banks, limited partnerships, and other associations not incorporated but operating under the corporate form, are taxed as corporations, and therefore the earnings received from such organizations are treated as dividends and are exempt from normal tax when received by an individual. So-called dividends paid by co-operative merchandising organizations to members or to patrons generally, in proportion to the amount of purchases made, are in fact discounts or rebates reducing the price of the merchandise and are not income to the recipient. In many states, shares of bank stock are taxed and the bank is required to pay the tax, although it is in fact a tax upon the owner of the share. Therefore, the amount paid for him by the bank, having been used to discharge his obligation, is income received by him, and such amounts should be included in the stockholder's Return as dividends received. A scrip or note dividend is regarded as cash to the face value of the scrip. Dividends payable in Liberty Bonds are not exempt, but are taxable income to the market value of the bonds when distributed.

6. Income From Other Sources.

127. **Rents and Royalties.** Gross income includes all amounts received as rents or royalties in compensation for the use of property. Any consideration received in lieu of money must be reported at its cash value when received. Crop shares are taxed for the year in which they are reduced to money or money equivalent. A building erected or other permanent improvement made by a tenant, as part of the rent, and received by the landlord at the end of the term is then to be included in the gross income of the landlord at its cost less actual depreciation. Interest and taxes paid by a tenant on behalf of the landlord are income of the landlord when paid, and may also be deducted by the landlord as payments made by him. Ordinary repairs made by the tenant are not income of the landlord but expenses of the tenant. The value of the use of property by the owner need not be accounted for as income of the owner, nor may it be deducted as rent paid.

128. **Partnership Profits.** A partnership, unlike a corporation, has no legal existence aside from the members who compose it and therefore the income which it receives belongs immediately to the partners with no declaration of dividend, just as if received directly by them. The income of the partnership for the calendar year or fiscal year must be shown on a partnership Return, but only the members are taxed. Each member must show on his individual Return his share of the net income of the firm for the period covered by the last firm Return, even though the money may remain invested in the business of the firm and can not be drawn out. When the Return of the partnership covers a fiscal year beginning in 1917, the individual will pay only the 1917 tax rates upon that part of his share which is proportionate to the part of the firm fiscal year which falls within 1917. This part of the member's share is also credited with the amount of Excess Profits Tax assessed under the 1917 Act against the partnership. A similar rule applies in all cases where the fiscal year of the partnership falls in two calendar years with different rates. Each member receives credit for his proportion of divi-

dends and exempt interest received by the partnership, and is allowed to deduct his share of the firm's contributions to charity, which are not deductible on the firm Return. As the income is taxed when earned, there is no further tax when the individual draws out his profits in money. A limited partnership association is treated like a corporation and the profits are taxed like dividends, only when distributed and then only for the surtax.

129. **Income of Fiduciaries.** The Return of an individual must include his share in the income received on his behalf by a fiduciary (defined in par. 39), whether such income has been paid over to him or not. Amounts received from fiduciaries as payment of legacies or other gifts is not income. The net income shown on the last Return filed by the fiduciary will be reported by the beneficiary even though additional amounts may have been received since the close of the fiscal year of the fiduciary and before the close of the fiscal year of the beneficiary. Where the fiscal year of the fiduciary falls within two calendar years in which different rates of tax apply, presumably the general rule of apportioning the income would apply, although the law is silent on this point. Where the beneficiary receives income upon which the fiduciary or estate has paid the tax, it is not subject to any further tax and is not shown on the beneficiary's return. The beneficiary receives credit for his share of the dividends and partially exempt interest received by the fiduciary.

130. **Gambling Gains and Illegal Profits.** Income includes amounts gained in gambling. Profits made in violation of criminal law or public regulation and income received in violation of the rights of individuals or corporations are none the less taxable.

131. **Payment and Release of Debts.** The payment of a debt is not income to the creditor, since it is a mere change in form of capital. Where one person pays a debt owing by another, it is either a gift or taxable income to the debtor. Where the debt of a corporation or individual is discharged or forgiven it may be income, if for consideration, but in the ordinary case of insolvency or reorganization is either a gift or contribution of capital or else a formal recognition of worthlessness, and in either case would not be taxable to the debtor.

(C) Deductions from Gross Income.

1. Expenses of Carrying on Business.

132. **Nature of Expense.** Individuals, partnerships, and corporations are allowed to deduct from their taxable gross income "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." To be included in this deduction, a disbursement or charge must have all of the following qualities: (1) It must relate to a trade or business carried on by the taxpayer; this excludes personal expenses, expenses of a serious activity other than a trade or business, and expenses of the business of another person, paid by the taxpayer on behalf of the proprietor. (2) The proceeds must be such as will be consumed or exhausted in a relatively short time, as

improvements or additions of permanent value are not included in the term "expense" (3) The expense must be "ordinary and necessary," and expenses may be disallowed if unreasonable in amount or purpose. The deduction for expense should exclude all items, such as taxes, which are specifically provided for by the law and the Returns, even though in the nature of expenses, and also certain expenses which are expressly made not deductible.

133. **Personal Expenses.** The law expressly disallows the deduction of "personal, living, or family expenses," which include rent paid for a home, wages of domestic servants, cost of food and clothing for the family, education of children, upkeep of pleasure automobile, and similar items connected in any way with the maintenance, well-being, or pleasure of the taxpayer or his dependents. Interest, taxes, casualty losses, worthless debts, and contributions to charitable organizations are deductible even when entirely personal and not related to a business, because they are the subject of specific provisions in the law, explained later. There have been rulings to the effect that hotel bills paid by actors and other travelers are not allowable as deductions because they represent food and shelter, which is personal, notwithstanding the fact that a permanent home is necessarily maintained elsewhere by the taxpayer. Where such expenses are paid by the employer they are deductible by him but may constitute additional income of the employee (see par. 79).

134. **Permanent Improvements and Additions.** The deduction for expense may not include investments of a permanent nature. Expenditures for the erection of buildings, grading of lawns, and other permanent improvement of property, for the installation of machinery, and for the acquisition of books, tools or implements of permanent value and similar unconsumable property, may not be deducted from the gross income since they are merely a change in form of capital and not a reduction of wealth. The test is whether a capital asset is acquired. Under certain circumstances, the value of property may so quickly disappear that it is properly charged as expense even though the physical existence of the property continues as in the case of dies, patterns, or designs to be used only for a single season, tools purchased for a single job, and replacements of property or parts not otherwise charged off. In general, the cost is not an expense where the property will continue in use after the expiration of the taxable year, but in certain cases the cost may be deducted partly in one year and partly in the next year as a deferred expense, if correctly charged on the books on the accrual basis. Where the cost of property is charged as expense, the entire amount of salvage value or proceeds of sale must be returned as income. If desired, property of temporary usefulness may be carried as an investment and charged off by a depreciation or obsolescence allowance, as explained at pars. 171 and 172. The Regulations hold that the following expenditures must be regarded as permanent investments and may not be charged as expense: cost of securing copyright and cost of plates; cost of defending or perfecting title to property; cost of plans and services of architect; expense of organizing corporation, procuring charter and selling stock; commissions paid on purchase and sale of securities or other property premiums on policy insuring life of

employee or officer of taxpayer and premiums on endowment policies; cost of experimental and development work, resulting in satisfactory designs, drawings, patterns, or models. These items are of importance in illustrating the rule that an expenditure resulting in a capital asset is not deductible.

135. **Activities Other Than Business.** "Trade or business" has been held to include professions and vocations. The trade or business of an individual is the pursuit or occupation in which he has invested money and to which he devotes part of his time and attention for the purpose of a livelihood or profit. A single transaction or a series of isolated transactions do not constitute a trade or business. A person may carry on more than one business or trade if he devotes sufficient time, attention, and capital to the enterprise. Mere investment of capital for profit is not enough. A coal merchant who speculates in stocks and bonds is not in the business of dealing in such securities. A corporation acts primarily for the sole purpose of carrying on a business or trade and all its transactions for profit are part of its business or trade. It may, however, incur expenses which are not directly connected with the main business but with collateral enterprises, such as the support of legislation and participation in public movements. There have been decisions that such expenses were not deductible, applying a narrow definition of "trade or business." Lobbying expenses and campaign contributions are not deductible, but the expense of belonging to commercial organizations is allowable.

136. **Unreasonable Expenses.** In extreme cases expenses actually incurred may be disallowed because they are so unreasonable in amount or so unusual in purpose as to cease to be "ordinary and necessary," although the managers of the business considered them required at the time. It is for this reason that Christmas presents and other donations made by corporations are not deductible, not being "necessary." The rule is that an expense is necessary where it is reasonably required by the interests of the business and objection will rarely be made on this ground to anything short of a donation, except where it appears that a business is being used as a cloak for disbursements really made for another purpose, is being carelessly and extravagantly inflated, or is being unlawfully despoiled of its property by means of padded charges made by persons in control.

137. **Payment Basis or Accrual Basis.** Expenses may be deducted on the payment basis or the accrual basis; that is, they may be deducted in the year in which paid, or the year in which they become due or are incurred although not paid. If the payment basis is used throughout, an expense may be deducted in the year in which paid, even though incurred in a prior year. Where the books are kept on the accrual basis, the expenses deducted must relate to the business of the taxable year and expenses not deducted in the year in which they are incurred can not be deducted in a subsequent year when paid. Of course, when expenses have been previously deducted on the accrual basis, the subsequent payment does not permit of any further deduction. No deduction may be made for purely "paper" charges, such as rental value of

business property owned by the proprietor or interest on the proprietor's capital employed.

138. **Expenses of a Mercantile Business.** All the ordinary expenses of a mercantile business may be deducted, including salaries (proprietor and employees), rent, light and heat, delivery expense, advertising, insurance, etc. Interest, taxes, losses, and depreciation should not be included as they are covered by separate deductions.

139. **Cost of Merchandise.** Strictly speaking, only the profit on a sale is income and the Regulations formerly required the cost of goods to be deducted from gross sales in order to find the gross income. At present, however, cost of merchandise is treated on the Returns as a general deduction. The total purchases must be shown as carried on the books, either on the payment basis or on the accrual basis, the latter covering invoices charged to accounts payable during the year. Actual prices, with discounts and allowances deducted, should be used; discounts should not be shown as income. In-freight may be added to cost or shown as expense. To find the actual cost it is necessary to add to the purchases for the year the amount of the inventories at the beginning of the year and to deduct the inventories at the end of the year.

140. **Inventories.** Inventories of merchandise held for resale must be used to determine net income and may be required in any other case where the Commissioner considers it necessary. Dealers in securities are permitted to use inventories when regularly employed in the books of account. The basis to be used may be fixed by the Regulations so as to most clearly reflect the income. Special regulations for particular cases and for special businesses are contemplated but at the present time the general requirements apply to all businesses. Inventories must be taken in one of two methods, either (1) at cost, or (2) at cost or market price, whichever is lower. The second method is susceptible of two applications, namely: (a) the entire stock may be inventoried at cost and also at market prices and the lower of the two inventories may be used; (b) in each item the particular goods may be entered at the lower figure, cost in some cases and market price in others. Only the second of these methods is recognized by the Treasury Department. The Regulations do not permit an inventory which will represent a market value which is more than cost, or a scaled down cost or market value in anticipation of future losses. The basis of inventory which is once adopted must be adhered to in future years, except where the change is authorized by the Commissioner. Where inventoried goods have become obsolete, damaged, or otherwise reduced in value, they may not be marked down on the inventory unless they are actually unsalable, in which event the Return must show the original cost, inventory value charged off, and present condition.

141. **Expenses of Manufacturing Business.** The expenses of a manufacturing business include labor and superintendence, raw materials, supplies, repairs, light and heat, power, selling cost, administration expense, and similar charges. Where the books separate direct cost from overhead expense, the cost of manufacturing or producing goods for sale should be separately reported on the Return, but if not separated

on the books may be included in the expenses. Greater accuracy is attained where materials and supplies are inventoried, so that the deduction will include only the amount actually consumed during the year, but if no inventory or record of consumption is kept it is permissible to include the total purchases made during the year. Finished goods held for sale must be inventoried and added to the gross sales, and it is desirable to do the same with work in process. All inventories must be taken in accordance with the requirements explained in the preceding paragraph.

142. **Expenses of Farmers.** An individual or corporation carrying on the business of farming may deduct amounts paid for labor used in producing crops or livestock, cost of seed and fertilizers, cost of feed, repairs to buildings, fences and machinery, expense of marketing, and similar ordinary and necessary expenses. The cost of farm machinery is a permanent investment, but the cost of ordinary tools, such as spades and pitchforks, may be deducted as an expense. The cost of stock purchased for resale is deductible in the year when the stock is sold to determine profit or loss, but may not at any time be deducted as expense. Stock purchased for dairy, draft or breeding purposes, is a permanent investment, and not deductible. The deductible expenses must be scheduled in the year in which they are paid or incurred, even though the product is not sold until a subsequent year, but if incurred prior to 1917 and not taken into consideration in ascertaining income tax liability, they may be deducted in a subsequent year from the selling price of the products to which they relate. Where books are kept according to some approved method of accounting and clearly show the net income, the Return may be made in accordance with the books. Under these circumstances, inventories may be used. The inventory for the beginning of the year must be the same figure as that reported for the end of the preceding year. It should include all live stock and products on hand, whether purchased or produced on the farm and whether held for sale or permanent use. Loss or destruction of live stock or products during the year will reduce the inventory and therefore are deducted from income in this way and not otherwise. Where inventory is not used, there may be a deduction for the loss of live stock or products if purchased, but not if produced on the farm since in that case expense of producing has already been deducted. Products of the farm will be inventoried at the cost of production, based on actual disbursements or at either cost or market price, whichever is lower. Farmers using inventories are allowed a method of deducting for shrinkage in value which is not permitted in any other case. Live stock held for permanent use may be included in the inventory for each year at a figure which will reflect the estimated reduction in value because of increase in age or other causes, such estimated reduction to be based upon cost and estimated life.

143. **Expenses of Salaried Employee.** The Regulations provide that expenditures incurred in earning a salary are deductible as business expenses. Thus the premium on a fidelity bond required by the employer is deductible. But it has been held that the cost of transportation between home and place of business is a personal expense, although there

is much reason and authority to the contrary. Where a man working on salary or commission pays his own office and traveling expenses, they are of course deductible. Hotel bills and cost of meals have been held to be living expenses and not business expenses. Uniforms and costumes required by the employment and not adapted to personal use are business expenses, but army officers may not deduct the cost of mounts and equipment.

144. **Expenses of Landlords and Tenants.** Where property is held for renting purposes, the owner may deduct the cost of securing tenants and the expenses of maintenance, such as ordinary repairs, light and fuel, janitor service, and insurance. Where the owner occupies part of the building as his dwelling, the expenses must be apportioned and only those relating to the part of the building which is rented may be deducted. A tenant may deduct the rent paid for business premises, which includes amounts which the lease requires the tenant to pay on behalf of the landlord, such as taxes and interest. The cost of ordinary repairs required to be made by the tenant are deductible by him as expenses, but not as rent. Frequently a tenant agrees, as part of the consideration for the lease, to erect a building or make other permanent improvements for the benefit of the landlord. The cost of such improvement is considered as rent and should be prorated over the term of the lease, so that a proportionate amount will be deducted in each year of the tenancy. A deduction for depreciation by the tenant is not allowable in such case, but the cost of ordinary repairs and maintenance may be deducted. Nor may the landlord deduct for depreciation, since he does not report the full cost as income, but only the cost less depreciation accrued at the end of the term (see par. 127). A premium paid to secure a lease or an amount paid for the assignment of a leasehold should be prorated over the term and deducted in each year as additional rent.

145. **Expenses of an Estate.** In computing the net income of a trust estate or the estate of a decedent, whether the estate itself is taxed or whether the income is divided among the beneficiaries, no deduction may be made for the expenses of administering the estate, such as court costs, attorneys' fees, and trustee's or executor's commissions, but these expenditures are regarded as reductions of the principal of the estate. If the estate is conducting a business, the expenses of the business may be deducted. Taxes, interest, and similar items, may also be deducted.

146. **Salaries.** The statute allows the deduction of "a reasonable allowance for salaries or other compensation for personal services actually rendered." A payment is not a salary if it is in fact paid for some consideration other than personal services, as in the following examples. Where the stockholders of a corporation draw salaries which in amount bear a close relationship to stock holdings, the payments will be closely scrutinized and if found to be in excess of a reasonable payment for services rendered, the excess will be regarded as a dividend paid under the guise of salaries. An excessive salary voted to the person or persons in control of a corporation may be held a wrongful appropriation of the property of the corporation, which is not deductible

by the corporation although taxable to the recipient, as are other illegal gains. Where a corporation buys out a business and agrees to pay salaries to the former owners, the salaries if excessive in amount may be held to include payment for the business or property purchased. Reasonableness is in all such cases the controlling test of deductibility; the volume of business, ability of the employee, responsibility of the position, and all like elements, considered in a bargain between strangers, may be determining factors. Where salaries paid exceed a reasonable amount the taxpayer has the burden of showing that they are actually and solely the purchase price of services.

147. **Salary Fixed After Service Rendered.** Compensation may be contingent in amount, as where it consists of a percentage of sales or profits. If the basis was fixed before the services were rendered and by a free bargain influenced only by considerations affecting the value of the services, the salary may be deducted even though the amount may finally prove to be greater than that which would ordinarily be paid. Where the compensation is fixed after the services are rendered and independently of any understanding or practice, it will not be deductible if it exceeds a reasonable amount such as would ordinarily be paid in other enterprises under like circumstances. This applies to so-called bonuses, profit sharing, and other special payments made after the profitableness of the services has been demonstrated.

148. **Special Questions as to Salaries.** For any period prior to March 1, 1918, reasonable salaries may be deducted by a corporation even though not formally voted, provided they are actually paid and are properly charged back on the books. Salaries paid to minor children may not be deducted by the parent, since he is legally entitled to the services and any payment is in the nature of a gratuitous allowance. Salaries paid to employees who are absent on military or other government service for the duration of the war may be deducted, since they tend to preserve the organization and secure the return of such employees. Compensation for services paid in capital stock of the company may be deducted at the actual value of the stock.

149. **Pensions and Compensation for Injuries.** Pensions regularly paid to employees or their dependents in case of death, retirement, or injury, may be deducted, but a mere gratuity, such as payment of the salary of a deceased employee to his widow in recognition of his service, may not be deducted. Compensation for injuries, paid pursuant to legal liability or pursuant to a settled practice in the absence of liability, is a deductible expense. A voluntary contribution by an employer to a pension fund or insurance plan conducted by the employees is not deductible unless made under circumstances constituting it in fact an element of the agreed compensation for services or a settlement of a liability of the business. If the employer holds the resources of such a fund, only the payments to the employees may be deducted and not the amounts appropriated to the fund.

150. **Donations and Gratuities.** Although it is certainly "ordinary" and usually considered "necessary" to make Christmas presents to employees and others, they have been held mere gratuities and not deductible expenses. Spending money furnished to salesmen and cour-

tesies, entertainment, and presents to customers are deductible when actually related to the sale of goods. Donations made to charities, war relief, exhibitions, and similar enterprises are not expenses and may not be deducted by corporations except where there is a direct business benefit, as where a hospital reserves a ward for the treatment of employees, or where an educational institution is conducted for the benefit of employees or their dependents. Charitable contributions made by individuals are deductible under a separate item (par. 182). A donation made purely to obtain or preserve the good will of customers or the public is not recognized as an ''ordinary and necessary'' expense, because the benefit is not sufficiently direct. Campaign contributions are not deductible.

151. **Repairs, Renewals, and Replacements.** Expenditures for maintenance and incidental repairs, which do not add to the value of property but merely keep it in good condition, may be deducted as expense. To the extent that such repairs prolong the life of the property, they have the effect of reducing the amount otherwise chargeable for depreciation. Expenditures which add to the value of property are not deductible but should be charged as an investment of capital. For example, a worn part of a machine may be replaced with a more modern part at a materially higher cost, resulting in a machine of greater value. The added value because of the new part should then be charged to property account. An expenditure for restoring property or making good exhaustion for which a depreciation charge has already been made may not again be deducted from income but must be charged against the depreciation reserve. (See also par. 177). Where property is replaced with other property of a greater value, the cost of replacement must not be deducted from the taxable income but should be charged as an addition to property and used as the basis for the depreciation deduction in the future. At the same time, however, a deduction may be made for the obsolescence of the discarded property (as explained at par. 164). For small items the cost of replacement, where not an expense of maintenance, may be charged against the depreciation reserve, but with large items this is apt to result in various substantial errors. If the property has not been charged off and is replaced with other property of the same value, the cost of the new property may be charged off as expense, where the effect is only to maintain the property at its book value, not to increase the value. In this case, however, the amount charged off must be reduced by the amount of any depreciation previously charged off on the old property and by the amount received for the discarded property or its fair salvage value. The cost of replacement should be charged off as expense where the property has only a short life and where its value disappears so quickly with use that a depreciation charge is not practical. The test is whether there is an addition to value or capital, which is not deductible, or a maintenance of value or capital, which is expense. (See also par. 134). The application of this test is illustrated by the following case. The Lakeborn Hotel Company entirely re-furnishes its lobby, charging the cost to an investment account. The old furniture is sold to a second hand dealer for a small sum. This latter amount and the total accrued

depreciation is deducted from the original cost of the old furniture and the balance is charged off as a loss. Purchases of dining room china amount to more than the original cost, but because of breakage, there is no more on hand at the end of the year than at the beginning. Therefore the entire amount of china purchases may be charged as expense, with no allowance for depreciation. The company also buys during the year enough bedding and linen to keep up its supply. If there has been an adequate depreciation allowance the replacements may be merely charged to the property account or the depreciation reserve, but if the total cost of the discarded property has not been previously charged off, there should be a further deduction from income for the loss in discarding it.

152. **Life Insurance Premiums.** No deduction is allowed for premiums paid by a business enterprise (corporate or individual) to insure the life of an officer, employee, or any person financially interested in the business, where the taxpayer is directly or indirectly a beneficiary. Such policy should be treated as an investment. But if the insurance is for the benefit of the employee who is insured, the amount paid as premium is an addition to his compensation and is deductible. Where the life of an officer is insured to secure his indorsement of a debt of the corporation, the premium paid is of course an addition to the expense of borrowing money, but apparently it may not be deducted because of the express provision of the statute. Premiums paid for term insurance are not deductible under these circumstances, but since such insurance does not have a permanent cash surrender value it would appear that a deductible loss is sustained when the policy expires during the life of the insured. Nevertheless, the Department has advised that the aggregate premiums paid may not be then deducted, as a loss or otherwise. Premiums paid by an individual to insure the life of himself or a member of his family, are of course personal expenses. For the exemption applying to the proceeds of life insurance policies, see par. 66.

153. **Fire Insurance Premiums and Reserves.** Premiums for fire, casualty, and other insurance are deductible when they are expenses of business, as when they cover property used in business or used for renting purposes, but not when they are personal expenses, as when they apply to a dwelling or a pleasure automobile. Where a corporation carries its own insurance, no deduction may be made for amounts appropriated to a reserve, which is in fact only part of the surplus set aside for anticipated losses, but the proper deduction may be made when the losses actually occur.

154. **Organization and Capital Expenses.** All expenses incidental to or connected with the incorporation and organization of a corporation and the sale of its capital stock or securing or increasing its capital must be treated as the cost of the franchise and must be excluded from the expenses deducted from gross income, since the Treasury Department holds that these are capital transactions and not expenses of "carrying on" business. Where a franchise has a limited duration or is of value for only a limited period, a deduction is allowable on the same principles as the amortization of a patent; or when the corporation is finally liqui-

dated and dissolved, the cost of the franchise may be charged off as a loss, since there is an actual disappearance of property. A discount upon stock sold or a commission for the sale of stock, whether common or preferred, may not be deducted at any time from the income from operations, since it has the effect only to reduce the capital of the company. These items may and should be charged off on the books, either at once or by deferred charges, even though reports to the government must then differ from the books.

155. **Development Expenses.** Advertising and similar development of the good will of a business may properly be charged as expense, even though the result is of permanent value. Experimentation and development of patterns, processes, inventories, and similar work is generally considered as expense, but the regulations require that it be treated as an investment. It is held that where designs, drawings, patterns, or models result in the production of saleable goods they will be treated as a capital asset, and the entire cost, including all experimental and development expenses, will be capitalized and not deducted as expense. Where such designs, drawings, patterns, or models prove unsatisfactory and have no asset value, the entire capitalized cost may be deducted as a loss if completely and satisfactorily explained on the Return, but may not be deducted as expense. Where experimental work results in patented inventions, the expenditures for the experimental work are to be added to the cost of the patent. There are so many objections to carrying as an asset such items as rent of a laboratory or cost of pencils and paper that a business should charge off ordinary experiment and development work for its own purposes, without deducting the amount from its income or from its surplus as reported to the government.

2. Interest.

156. **Deduction of Interest Paid or Accrued.** Corporations and individuals may deduct without limit, ''all interest paid or accrued within the taxable year on indebtedness,'' except for the restriction as to indebtedness for carrying tax-exempt securities. Whether the accrued interest or interest paid is the basis of the deduction will depend on the methods followed in the books of the taxpayer. If interest accrued in former years has never been charged against income it may be deducted in the year when paid; it may be deducted when paid in advance if at once charged off. Interest neither paid during the year nor accrued for the year can not be made deductible merely by charging it on the books. The deduction may include interest upon personal debts, such as a mortgage on a dwelling or a judgment for a grocer's bill, as well as upon business debts, and also interest upon secured indebtedness. Banking corporations will include interest on deposits and certificates of indebtedness. Interest is not deductible in this item unless paid upon indebtedness of the taxpayer. For example, where a corporation pays the interest upon a mortgage on property in which it has no equity but which it occupies as a tenant, this amount is deductible only as an expense for rent. A mortgage debt upon property in which the taxpayer has an equity or to which he is taking title is construed as

an indebtedness of the taxpayer even though not assumed by him. Taxes paid on tax-free bonds (defined at par. 114) are in fact additional interest or expense of borrowing money, but it has been held that corporations paying federal, state, or municipal taxes pursuant to such covenant will not be allowed to deduct this payment under any item.

157. **Indebtedness to Carry Tax Exempt Securities.** The interest deduction must not include any interest paid on "indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is wholly exempt from taxation under this title." A taxpayer may not borrow money to buy state or municipal bonds, use the exempt interest to pay the interest on the loan, and then deduct the interest so paid from his other income which is taxable. Although the interest paid may exceed the interest received, the excess is not therefore deductible but the entire amount paid upon such indebtedness must be excluded. Since shares of stock bear dividends and not interest, there is a question whether the statute excludes interest paid by a corporation on indebtedness incurred or continued to carry dividend-paying stock. Such interest would be deductible by an individual, since as to him the dividends are not wholly exempt, as they are to a corporation.

3. Taxes.

158. **Taxes Paid or Accrued.** Taxes assessed by the United States, the states, or political subdivisions, excepting Federal Income and Profits Taxes, may be deducted when paid or accrued. Special assessments for local benefits of a kind tending to increase the value of the property are excluded by the law since they are in fact the cost of a permanent improvement. Water rates and like payments for service are not taxes but expenses, deductible if properly incurred in carrying on business. The same is true as to fees for special privileges or permits, such as an automobile license or an annual charge for the use of a street, but where a license, permit, or franchise has a permanent value, the fee should be charged as an investment and not as a reduction of income. Inheritance taxes are not deductible, since they do not reduce the income of any one but are taken from the principal in course of transfer. Customs duties should be included in the cost of property when possible, but when paid upon articles not imported for sale they may be deducted as taxes. Excise taxes, stamp taxes, and similar taxes should be similarly treated. Thus an individual may deduct the war tax paid upon theatre tickets.

159. **Taxes on Bank Stock and Tax Free Bonds.** Taxes are often levied upon the shares of stock in banks and other corporations, which the corporation is required to pay on behalf of the owners of the stock. The tax may not be deducted from the income of the corporation, but may be deducted by the individual stockholders as taxes paid. On the other hand they must include, as part of their income from dividends, this same amount of taxes. This rule does not prevent the corporation from deducting the Federal Capital Stock Tax or any state

excise or franchise tax, paid to transact business within the state, imposed upon the corporation itself but based upon the value of the shares. Likewise, taxes paid on behalf of the holders of tax-free bonds (defined at par. 114) are not deductible by the corporation, but the holders of the bond may deduct any taxes so paid other than the Federal Income Tax.

160. **Foreign Taxes.** Deductible taxes, in the case of a citizen, resident alien, or domestic corporation, include also those assessed by foreign countries, other than income or profits taxes. Income or profits taxes assessed by a foreign country or a possession of the United States against a domestic corporation or a citizen (or assessed by a possession of the United States against a resident alien) are credited toward the tax found to be due upon the net income computed with no deduction for such tax. To illustrate: Where the Return of a nonresident citizen shows a net income of $30,000, after deducting property and personal taxes paid to foreign countries, and a tax liability of $1,450, and also shows that an income tax of $980 was paid during the taxable year to the government of the foreign country where the citizen resides, the foreign tax would be deducted from the amount otherwise due, leaving the United States tax $470. A foreign corporation or nonresident alien is not allowed this credit. A resident alien is allowed a similar credit for such tax assessed by the country of which he is a citizen or subject, on condition that a like credit is allowed by that country to citizens of the United States residing there. A domestic corporation will be allowed similar credit for a proportion of income or profits taxes paid by a foreign corporation of which it owns a majority of the voting stock, to any foreign country upon income derived from foreign sources. The proportion shall be the same as that which the amount of dividends, not exempt from tax, received by the domestic corporation, bears to the total income of the foreign corporation upon which the foreign taxes were paid. The amount of this credit shall in no case exceed the amount of taxable dividends received by the domestic corporation.

4. Losses.

161. **Losses Sustained.** Losses must be separately reported, with the explanations required by the Regulations, and should not be included in the Expenses or in any other deduction. Common to the various kinds of deductible losses is the requirement that they be sustained. It is held that a loss is not "sustained" when it reflects a speculative or fluctuating valuation of a continuing investment, but only after it has been determined and ascertained upon an actual, completed, and closed transaction, and after the amount involved has irredeemably disappeared from the assets of the taxpayer. A person may feel certain that real estate which he owns is worth much less than when he bought it, or that some of the stock in his store will never be sold until he marks it below cost, and it would ordinarily be said that he had lost money in both cases. But no deduction may be made for anticipated losses, however probable, for which reserves are set up, nor for shrinkage in the value of the property until made absolute by sale or disposition of

the property, even though such shrinkage may be charged upon the books and proved by expert appraisal or other evidence of the highest credibility. (See par. 60). This rule applies to corporations as well as to individuals.

162. **Kinds of Losses.** Individuals must separately report: (1) losses incurred in trade or business; (2) losses incurred in a transaction entered into for profit but not connected with the trade or business; (3) losses not connected with the trade or business arising from fire, storm, shipwreck or other casualty or from theft; (4) debts ascertained to be worthless and charged off. As to corporations, the law distinguishes only between debts charged off and other losses. To the extent that a loss is covered by insurance, there is of course no loss to the owner. Losses may be deducted only in the year in which they are incurred, even though the cost of replacing the asset which the loss represents is properly distributed over several years. For example if a dwelling house burns down and is not covered by insurance, the loss sustained must be deducted from the income of the same year. If the value of the destroyed house is more than the entire year's income of the owner, he is not entitled because of that fact to deduct part of the loss in one year and part in the next. (But see pars. 165-166.)

163. **Loss on Sale of Property.** The loss sustained by the sale of property is determined according to the same rules which apply with reference to profit (pars. 97-111). Loss of this kind consists in general of the difference between the selling price and the cost, except that cost and selling price must be ascertained in the same manner as has been explained with reference to profit and where the property was owned prior to March 1, 1913, the value of that date is used instead of the cost.

164. **Losses on Obsolete and Discarded Property.** Where old buildings are removed or old machinery or equipment is scrapped, to be replaced by similar property or merely to be withdrawn from use, a deduction may be made for the loss sustained, since this is regarded as a closed transaction if the property definitely and finally disappears from the assets of the taxpayer. It is held, however, that where real estate is purchased for the purpose of erecting new buildings, no deductible loss is sustained by reason of the destruction of an old building standing upon the real estate, but the sum of the cost of the real estate and old building and the cost of removing the old building will be considered the cost of the real estate, or the amount paid for the old building and the destruction of it may be included in the cost of the new building being erected. The loss when property is destroyed or discarded is determined by deducting from the cost of the property (as defined in par. 101); or its value on March 1, 1913, the sum of (1) the amount received for the property when it is disposed of or its fair salvage value at that time if no sale is made, (2) the total amount that has been previously deducted and claimed on account of the depreciation or obsolescence of the property, (3) any additional amount of depreciation actually sustained and which might have been deducted, but which has never been charged off. (See Illustration at par. 209). The deduction for loss in the taxable year may not include any amounts which

were actually lost by reason of the depreciation of the property in prior years, but such depreciation must be claimed for the year in which it occurred. In this connection it must be remembered that allowable depreciation formerly covered only physical wear and tear, and a charge to cover anticipated obsolescence has not been recognized as an allowable deduction. Therefore the loss sustained upon discarded property would not be reduced by reason of the fact that it included obsolescence which has been gradually occurring over a period of years. The amount deducted must be properly recorded on the books of the taxpayer and the Return must be accompanied by a statement showing the facts in sufficient detail to clearly establish the amount and fact of the loss. Where patents are found to be entirely worthless before their cost has been charged off by means of the allowable depreciation deduction, the balance may also be deducted as a loss in this way. The same method governs the determination of loss where property is damaged or destroyed. No deductions are allowed for damage or reduction in the value of merchandise or material carried in stock until it becomes unsalable or unusable by reason of obsolescence or damage. When this condition exists, the deduction of the cost or inventory value may be claimed as a loss.

165. **Credit for Losses of Another Year.** Income Taxes for one year may be reduced on account of losses in excess of income, sustained in a taxable year beginning after October 31, 1918, and ending before January 1, 1920, if in connection with (a) operation of a business regularly carried on by the taxpayer or (b) the sale of plants or facilities acquired after April 5, 1917, and used in the production of articles contributing to the prosecution of the war. If the income of the year is sufficient to cover the losses sustained in that year, the entire deduction must be made from the current income, but where the losses exceed the income as otherwise computed, the difference or net loss for the year when proved by satisfactory evidence may be used to reduce the taxable net income of the preceding year under this provision, and the taxes paid for that year shall be refunded accordingly. Where the loss exceeds the income of the preceding year the excess shall be deducted from the income of the succeeding year. The net loss, as reported upon income tax returns, must be reduced by the amount of untaxable interest and dividends received during the same year the loss was suffered. The provisions extend to the members of partnerships and the beneficiaries of estates which sustain net losses.

166. **Loss in Value of Inventory.** A reduction in the value of the inventory of a business, which occurs during the taxable year is of course reflected in the net income if the goods in question are sold during the taxable year and is also reflected in the income if the inventory at the end of the year is taken at the market price when lower than cost. If the reduction in the value of the inventory occurs in the following year, the loss would normally reduce the taxable income of that year in the same manner, but a special provision, due to the inflation of prices resulting from war conditions, permits the adjustment of the Return for the taxable year ending in 1918 where the inventory for the end of that year is the subject of a substantial reduction which actually occurs in

the following year. It is not necessary that such reduction be realized by sale, but it must be proved by evidence satisfactory to the Commissioner. The reduction must be material and must not be a temporary fluctuation. A readjustment of the same kind will be made where rebates are paid in 1919 upon sales made and accounted for in 1918, if the payment is pursuant to contracts made in 1918. In advance of interpretation of the law, it is impossible to state what requirements will be made or what restrictions will be imposed as to the identity of the goods inventoried and the goods held at the time the reduction occurs. Obviously the amount which is deducted from the income of the first year must also be deducted from the figures used to determine the profit of the second year.

167. **Worthless Debts.** Bad debts, which have been actually ascertained to be worthless and have been charged off during the year, may be deducted. The Return must show some evidence of the manner in which the worthlessness was ascertained, that is, it should state that the debtor was discharged in bankruptcy or disappeared leaving no property, or that the ordinary methods of collection have been exhausted, or similar facts. If the bad debt represents taxable income, the deduction will be allowed only if the sum has been included in a Return of Income. A man takes a promissory note for two months' salary in 1916, but does not include it in the Return as income. In 1917, he actually ascertains that note is worthless and attempts to deduct it from his income for that year. The deduction will not be allowed because the debt, if collected, would be taxable income, and the fact that some expected income is not received does not reduce the income. But the rule is otherwise, if the note has been taken for a loan; then the payment would not be income when received and the failure to collect results in an allowable deduction.

168. **Losses on Securities.** Bonds are debts, and when they are ascertained to be worthless and charged off, the face amount may be deducted. Stocks are not debts and when they become worthless there can be no deduction except for the loss realized when they are sold, or when they cease to exist as property because of the dissolution of the corporation. Losses incurred in the sale of bonds and stocks are ascertained according to the principles applying to other kinds of property, but no deductible loss arises merely because the market value of securities has decreased.

169. **Bonds Issued at Discount or Redeemed at Premium.** A corporation may deduct the loss incurred in selling its own bonds below par. Suppose the Fidelity Corporation issues bonds for $960 each, which it must pay in ten years at $1,000 each. There is obviously a loss of $40 on each bond and, although the loss is not actually sustained until the bonds are paid, the liability accrues at once and the corporation is allowed to prorate the loss over the life of the bonds, deducting in each year one-tenth of this loss. It is not permissible to deduct the entire amount the first year. The same rule applies to selling commissions and other expenses incurred in issuing the bonds. The premium paid for the redemption of bonds is also a deductible loss. It has been held that the corporation may deduct as a loss all that it pays in excess of what it originally receives. For example, if the ten-year bonds of the Fidelity Corporation which, in our illustration, were issued at 96, are redeemed

after five years at par, the corporation would then have deducted only one-half of the loss under the prorating plan described; therefore it may now deduct the other one-half. If the bonds are redeemed at 102, the loss which may be then deducted is 2 points (or $20 on a $1,000 bond) greater. Suppose now that the bonds were issued at 102 and the corporation included the $20 premium in its taxable income. It may subsequently deduct the $20 when it redeems the bonds at 102. If, in that case, the whole amount received had been treated as capital and not as income when received, then there is no loss when the same amount of capital is repaid.

170. **Capital Stock Issued at Discount or Redeemed at Premium.** As has been pointed out (par. 154) any discount upon the issue of capital stock or expenses incurred in selling such stock or raising the capital is entirely a reduction of capital and may not be deducted from the income of any year, by prorating or otherwise. Similarly, the redemption of capital stock at a premium does not constitute a deductible loss. The preferred stock of a corporation is in many cases redeemable at a premium, say 105. In case such stock has been issued at par, its redemption would reduce the surplus of the corporation, but because the transaction is entirely a reduction of capital and does not affect the income, the loss incurred may not be deducted.

5. Depreciation.

171. **Physical Exhaustion of Property.** The law permits the deduction of "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business." This deduction must be made as a separate item of the Return, and must be explained according to the instruction on the Return by showing separated for each class of property its character, cost or value on March 1, 1913, estimated life, depreciation charged for the taxable year and total depreciation charged for all prior years. It represents an actual physical loss, which can not be escaped or diminished by bookkeeping, so that it is not necessary that there be any reserve fund created or maintained. Corporations, however, must charge depreciation upon their books or the deduction will not be allowed. Although the loss is actual, nevertheless the measure of it is necessarily a matter of estimate and is governed by the rules explained below.

172. **Obsolescence.** The 1919 law expressly permits the deduction of a reasonable allowance for the obsolescence of property, which means the decline in the value of property by reason of its becoming out of date. It is generally understood to indicate a process which is gradual and more or less certain at all times, rather than an anticipated sudden effect. It should apply to all property of which the value is known to be disappearing because of progress in the industry, changes in style and social conditions, and other circumstances depending on the mere passage of time rather than on physical exhaustion. The allowance will probably be included in a single deduction which covers also the physical exhaustion, but it represents a distinct and different loss. It implies an estimate of the length of time in which the property

will become out of date, so that it will have to be discarded or replaced with more modern property, and an annual charge against income to provide for this anticipated loss. Such a charge involves a very great degree of pure guesswork and many practical difficulties in connection with the administration of the law. It has not heretofore been allowed by the Income Tax Law and Regulations, and until the new Regulations appear the requirements for computing and establishing the deduction can not be stated. The special deduction for Amortization (par. 179) provides for the obsolescence in war industries. Furthermore, if property is found to be obsolete and worthless before its cost has been returned or set aside by means of the depreciation and obsolescence allowance, the remaining cost may be at that time deducted from the current income, as a loss, as explained at par. 164.

173. **Shrinkage in Value.** Mere shrinkage in value, not the result of physical exhaustion or gradual obsolescence, is not depreciation and is not deductible under this heading. For instance, stock and bonds, the good will of a business, or unimproved real estate, cannot be the basis for any depreciation allowance. No allowance for the exhaustion or reduction of the fertility of farm land has been recognized.

174. **Applies Only to Business Property.** Depreciation is deductible only in connection with property used in the trade or business and therefore individuals are not allowed to deduct the depreciation sustained by property for personal use, such as a pleasure automobile or a dwelling house. The owner of property which is rented to others as a source of income may deduct the depreciation of such property. Where the dwelling is partly used for business, as where a physician has his office in his home or where the owner of an apartment building occupies part and rents part, the appropriate portion of the total depreciation may be deducted.

175. **Determination of the Allowance.** The nature and purpose of the allowance for depreciation is to properly charge against and appropriate from the apparent income, what is really payment for the exhaustion or disappearance of capital, so that worn out property may be replaced without additional investment by the owner and the original investment may be returned unimpaired to the owner when the business is liquidated. It is thus obvious that the depreciation allowance has been excessive where it results in extinguishing the entire cost of property which remains valuable and continues in use in the business, and equally obvious that the allowance is deficient if the property is actually worth less before the cost has been charged off by the depreciation allowance. If the property continues in use after its cost has been charged off no further depreciation may then be claimed. If the property is actually discarded before the end of the estimated life, that part of the cost which exceeds the proper allowance for depreciation, may then be deducted as loss. In addition, the allowance deducted in each year should represent the amount of loss which has accrued during that year, so that the net book value will be representative of the actual value of the property. If the allowance is excessive, the income of each year is unduly reduced and the Return is incorrect. If the allowance is insufficient, the profits of the business are illusory rather than

real and the surplus which is included in the invested capital must be reduced by deducting a proper allowance for the depreciation and obsolescence which has actually occurred. Although property does not wear out to exactly the same extent every year, the best practice and the Regulations of the Treasury Department require that the same allowance be made in each year, determined by dividing the original cost of the property (or value on March 1, 1913), less its estimated value if any when worn out or discarded, over the estimated number of years for which it will probably be of service. The fact that no deduction, or insufficient deduction, was made in prior years does not warrant a greater deduction in any current year. Where property was acquired prior to March 1, 1913, its value as of that date may be used as the basis for the deduction, but it will be presumed, in the absence of proof to the contrary, that such value is the original cost less depreciation up to that date. In making the estimate of probable life, it is not required that the actual collapse of a building or disintegration of a machine should be contemplated, but that there must be an estimate of the number of years for which the property will remain suitable for the purposes for which it was acquired, with proper allowance for the estimated salvage value at the end of that time. The estimate should assume that the property will be maintained in good repair during the period.

176. **Rates of Depreciation.** The Treasury Department has refused to announce or approve any fixed rates of depreciation, properly holding that the rate must in each case depend upon the circumstances of the particular case, including not only the nature of the property, its age and condition when acquired, and the character of its use, but also the extent to which it is maintained. The following rates, however, are suggestive of the proper allowance for physical exhaustion, not including obsolescence, under average conditions; frame buildings 4%-10%; brick buildings, 2%-3%; brick-and-steel buildings, 2%; reinforced concrete and stone buildings, 1%-2%; automobiles, motor trucks, and farm tractors, 10%-25%; horses and wagons, 15%-25%; light or rapidly operating machinery, 20%-30%; heavy machinery, 5%-10%; boilers, steam piping, engines, heating and ventilating systems, turbines, generators, wire, motors, batteries, mine and mill equipment, 5%-10%; patterns and tools, 20%-25%; office furniture and books, 20%. Where machinery is run overtime, the depreciation is greater than where the equipment is used only during the regular working hours, which illustrates the general rule that all of the facts involved must be taken into consideration.

177. **Relation to Repairs.** The depreciation allowance should be determined upon the assumption that the property will be kept in reasonable repair. The amount of repairs and replacements of course affects the extent of the physical exhaustion, and it is moreover conceivable that property may be maintained to such an extent that there is no depreciation. In such a case the cost of repair and replacement might properly be charged to expense and then no deduction for the depreciation would be allowable or, on the other hand, the cost of new parts might be charged against the existing depreciation reserve, in which event the usual allowance should be deducted. Thus the practice in

charging repairs and replacements is one factor in the reasonableness of the depreciation charge. The proper purpose of the depreciation allowance, however, is to cover the decline which occurs in spite of the proper maintenance of property and it therefore does not conflict with the deduction of such maintenance as is properly chargeable to expense. On the other hand, if the exhaustion of property has been the subject of an allowance for depreciation in a previous year, the expense for making good such exhaustion, even though it might ordinarily be considered current maintenance, must be charged against the reserve or previous allowance for depreciation and cannot be deducted from the current net income. Since the theory of the depreciation allowance is that at the end of the estimated life the owner will have no property but will have its value set aside, he is not entitled to deduct from his income the cost of replacing the property for which the investment has already been set aside, nor may he deduct any allowance for exhaustion which is in fact made good out of income. He is not entitled to end the period of estimated life with both the value of the property and the property itself, without having paid income tax upon his gain.

178. **Depreciation of Patents.** It has been held that the disappearing value of a patent may be accounted for by the deduction of depreciation. The value on March 1, 1913, or if subsequently acquired, the actual cost, either the price paid for an assignment or the cost of securing the patent from the government, making models and drawings, etc., should be pro-rated over the seventeen years of the life of the patent and 1/17 deducted in each year. If it was purchased when only part of the full term remained, the price then paid should be pro-rated by the purchaser over the number of years of remaining life.

6. Amortization of War Plants.

179. **Anticipated Decline in Value Deductible.** A special deduction is provided for, in recognition of the losses which will be sustained by reason of peace readjustment and the shrinkage in value of property acquired at high prices for war industry. It is limited to buildings, machinery, equipment, or other facilities which have been constructed or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, and to vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the present war. Regulations to be issued will describe the articles which will be recognized as contributing to the prosecution of the war and will prescribe the form of proof which must be furnished to show that the plant was used in such production or acquired for that purpose. The anticipated loss upon such property may be charged off from the taxable income before it has occurred by deducting an estimated amount from the net income of the taxable year 1918 and subsequent years. The allowance must be based upon the amount actually invested by the taxpayer after this country entered the war, with allowance for the estimated value of the property under peace conditions and the amount of cost which will be returned from

income through the normal depreciation charge, which is distinct from and in addition to the amortization allowance. To illustrate: The Newton Button Company in December, 1917, invested $5,000 in special machines and additions to its equipment for the purpose of making certain machine-gun parts. It is estimated that this property will remain in use well into 1919, but that it must then be either discarded or remodeled and converted to other purposes. It is estimated that it would bring not more than $500 upon a sale at that time but that with an additional investment of $2,000 it could be converted into machines normally worth $3,000 to the Newton Button Company. The total anticipated loss during the two years of use will therefore be $4,500 if the property is sold, or $4,000 if it can be used by the company. Physical depreciation is estimated at 10% or $500 in each year, leaving $3,500 or $3,000 to be amortized. The company anticipated a favorable outlook and an available surplus for expansion in 1919, which will induce it to retain the property, and therefore figures the loss at the smaller amount, deducting $1,500 for amortization in 1918 and also in 1919.

180. **Adjustment After Actual Loss is Established.** At any time within three years after the conclusion of the peace treaties or proclamation by the President, the Commissioner of Internal Revenue may of his own initiative have the property appraised or receive other evidence of the actual shrinkage in value, to determine whether the allowance was correct. If not, the Returns for the years affected shall be revised and the taxes redetermined, any excess being refunded and any deficiency being collected. During the same period, the adjustment must be made upon request of the taxpayer. Thus the Newton Button Company, in the illustrative case above, may find itself unable to retain the property and may sell it for $500 in 1920. Instead of charging off the remaining $400 as a loss in 1920, when the rate of tax is lower, the company may apply for an adjustment of its 1918 and 1919 returns and receive credit for this loss against the income to which the high Profits Tax applied. Or, on the assumption that the company retained the property, the commissioner may in 1922 have it appraised as of the end of the war. If it should then be found that its fair value was $2,500 instead of $1,000, at which it was estimated, the additional $1,500 will be added to the 1918 and 1919 income of the company and the appropriate Income and Profits Tax will be assessed. If the loss has been estimated fairly and in good faith no penalties will be imposed, but any attempt to evade the tax will be punishable by all the fines and penalties for false Returns.

7. Depletion of Natural Resources.

181. **Allowance for Mines, Oil and Gas Wells, Timber, Etc.** In view of the special character of the income realized by the conversion of natural resources, the law contains special provisions for deducting from the gross income an allowance for returning the investment which is exhausted by the operations. In such a case the entire price realized for the product is not income but represents in part the capital originally invested in the property in its natural state and only in part the pro-

ductive operation. It is first necessary to estimate the quantity of mineral or standing timber as of March 1, 1913, or when subsequently acquired. The value on March 1, 1913, of property then owned or the exact cost of property subsequently acquired must then be divided over the total quantity, thus fixing the amount of capital invested in each unit. Cost may include cost of development not otherwise deducted, but must not include the cost of physical property upon which depreciation may be claimed nor the cost of any other property except the natural resources. The law further provides that where mines or oil wells or gas wells were discovered by the taxpayer after March 1, 1913, the depletion allowance may be based upon the fair value of the property within thirty days after the discovery of the natural deposit, rather than upon the cost to the taxpayer, provided that such value is materially disproportionate to the cost. The amount thus fixed may be charged for each unit removed during the taxable year. Neither the unit charge nor the total investment can be changed after once being fixed but must be adhered to in all future years. The amount of the investment and the amount charged in each year must be carried by the taxpayer in appropriate ledger accounts and when the original investment has been extinguished, no further deduction will be allowed but the entire price received will be income. In the case of oil wells or gas wells, if the quantity can not be determined with any degree of certainty, the allowance may be computed on the basis of reduction in flow and production, reducing the investment by the same percentage as the annual production is reduced. Amounts invested by lessees in addition to royalties and other deductible items may be extinguished upon the same plan.

8. Contribution to Charities.

182. **Certain Donations Deductible.** Contributions or gifts, made within the year covered by the Return to certain classes of charitable organizations, may be deducted by an individual to an amount not in excess of 15% of his net income as computed without the benefit of this deduction. This deduction is not allowed to corporations. The members of partnerships in computing their net income, may individually take credit for their proportion of such gifts made by the firm. The contributions may be deducted, only if verified under rules and regulations which will be prescribed, and only if made to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children and animals, no part of the net income of which inures to the benefit of any private stockholder or individual, or to the special fund authorized by Congress for Vocational Rehabilitation. Gifts made to individuals are not deductible. Donations to an organized church for any activity in furtherance of religion are deductible. In computing the net income of an estate or trust, there is allowed, instead of this deduction, the amount which, pursuant to the will or deed creating the trust, is during the taxable year paid to or permanently set aside for (1) the United States, a state, or a political subdivision, or (2) a corporation or association such as above described.

PART 4. RETURNS AND PAYMENT OF TAX.

183. **Time for Filing Returns.** Returns of individuals and corporations must be filed on or before March 15 of each year, or the fifteenth day of the third month following the close of the fiscal year where made on the basis of a fiscal year. If the last day for filing the Return falls upon a Sunday or legal holiday, the Return is in time if it is filed on the next day. In case of sickness or absence of the person who is required to execute the Return, but not for other causes, the collector of internal revenue may grant one extension of not to exceed thirty days, upon written application therefor, made before the Return is due. The Commissioner may allow an extension of not more than six months whenever in his judgment good cause exists, and for an unlimited time in case of taxpayers who are abroad. If the Return is not filed in time, the taxpayer is subject to a penalty of $1,000 and, unless it is shown that the delay was due to a reasonable cause and not wilful neglect or mere oversight, to a further penalty of 25% of the amount of the tax. The consequent delay in paying the first or subsequent installments is also subject to penalty.

184. **Filing by Mail.** The Return may be mailed to the collector, and will be considered as on time if it is placed in the mails, properly addressed and postage paid, early enough so that it would, in due course of mail, reach the collector within the required time. The Return is not filed in time merely because it is deposited in the mails on the day the office of the collector of internal revenue for the district in which that it should be filed.

185. **Place of Filing.** The Return of an individual should be filed where such person resides or has his principal place of business. The Return of a corporation should be filed in the office of the collector of internal revenue for the district in which is located the principal office of the corporation, where are kept its books of account and other data from which the Return is prepared.

186. **Return Made by Agent.** When the person required to make a Return is unable to do so because of illness, minority, insanity, absence, or non-residence, it must be done by an agent having sufficient knowledge of the affairs and property of the taxpayer to enable him to make a complete and true Return. A person acting under a power of attorney in the management of property is not obligated to make a Return, nor will a Return by any agent, in the absence or inability on the part of the principal, discharge the legal liability of the principal.

187. **Understatement and False Returns.** The collector may require any taxpayer to produce evidence in support of his Return and to submit to examination with reference to all items in it, and may increase amounts which he finds to be understated. An appeal may be taken to the Commissioner of Internal Revenue if the taxpayer objects to such an increase. The Treasury Department also employs a large number of investigating agents with authority to examine the books of taxpayers to discover errors, omissions, and evasions in Returns, and may assess any additional taxes. Except where the Return was false or fraudulent, such assessment must be made within five years from the date when the

return was due or was made. If the facts given on the Return show a tax liability greater than that reported, the additional amount may be assessed without change in the Return. In every case where a Return contains a false or fraudulent understatement made with intent to evade the tax, or is wilfully false or fraudulent, a penalty is imposed of 50% of the amount by which the tax is understated, or the same percentage of the entire tax in any case of false or fraudulent Return other than understatement. In addition, any wilful attempt to defeat or evade the tax is punishable by fine of not more than $10,000 or imprisonment for not more than one year, or both. Where the understatement is due to negligence, even though without intent to defraud, the penalty is 5% of the deficiency in tax, plus interest at 1% per month on the deficiency in each installment from the time when it was payable. If the Return is made in good faith and an understatement occurs without any fault of the taxpayer, there is no penalty but the tax will be increased to the proper amount. If a further assessment is made because of an incorrect Return, the taxpayer is bound by such assessment unless it is proved that the Return was not wilfully false or fraudulent and did not contain any wilful understatement or undervaluation.

188. **Rejected and Amended Returns.** Frequently collectors refuse to accept Returns which do not conform to their ideas of computation of the tax, but this exceeds their authority. If the Return is completely filled out and properly executed the taxpayer may demand that it be filed. If the collector considers it incorrect, he may report the facts for assessment according to his opinion. The investigating agents also prepare amended Returns where they find additional tax to be due, and generally urge the taxpayers to sign them. Executing such a Return may preclude any objection to the contents or to the assessment based upon it. The law imposes upon every person, whether subject to tax or not, the duty of truly stating the facts, and authorizes the Treasury Department to prescribe the form and manner of statement. All the information required by the Regulations or by the directions on the Returns must be given, but the taxpayer cannot be compelled to swear to statements which he does not believe are true. He should therefore make his Return according to his own information and his own conscience, acting upon the best advice available, and should refuse to alter it until convinced that he is wrong. Where an error in a Return is discovered after it has been filed permission to file an Amended Return should at once be requested. The Amended Return may accompany the request. If additional tax liability appears, an affidavit should also be filed, stating fully the cause for the difference and claiming the abatement of penalties for delay and false return.

189. **Time of Payment.** The Income and Profits Taxes are due in four equal installments on March 15, June 15, September 15, and December 15. Except for the first installment, which is due without any bill or notice, payment need not be made until notice of assessment has been given. Payment of the whole tax may be made on or before the due date of the Return, but no discount is allowed. Where the Return is filed on a fiscal year basis, the installments are due when the Return is due and in the third, sixth, and ninth months thereafter. An extension

of time for filing the Return postpones the time of payment of the first installment, but not the subsequent installments unless the Commissioner (not the collector) provides otherwise. Where the extension was granted at the request of the taxpayer, interest is charged on the first installment at the rate of ½% per month from the original due date, but no interest is added if the time is extended by a general order. It will be noted that the due date of payment relates to the time when the Return is due, not when it is filed. If any installment is not paid when it is due, the whole amount of the tax becomes due and payable upon notice and demand by the collector. The tax may also be declared due and payable in advance of the regular dates because of the taxpayer's design to take some action prejudicing the collection of the tax. If too small an amount has been paid upon any installment because of an understatement in the Return, the deficiency is due upon notice and demand. Any amount paid in excess of actual liability will be credited against future installments or refunded.

190. **Means of Payment.** Payment must be made in cash or bank check or draft which will not involve cost of collection. Collectors will receive uncertified checks and the tax will be considered paid as of the date the check is received, provided that it is not later dishonored. If a check is not paid upon presentation, the liability for the tax and all penalties is revived.

191. **Penalties for Delinquency in Payment.** The penalty for delay in paying any installment is 5% of the amount, plus interest at 1% per month from the date fixed by the notice and demand from the collector. On the first installment, the penalty and interest accrue from the date when the Return is due and the instructions on the Return constitute the only notice and demand which is required. The penalties do not attach against the estate of a deceased, insane, or insolvent person.

192. **Assessment, Collection, and Refund.** Taxes, interest, and penalties other than the specific fines, may be collected without court action, by seizure and sale of any property of the delinquent. The amount due may also be collected by court action. No proceeding to collect taxes may be begun after five years from the date the Return was due or was filed, except where the Return was false or fraudulent with intent to evade the tax. The collector gives notice of assessment and demands payment, fixing the time when he will proceed to enforce collection. The notice may be mailed and it is then presumed that it was duly received, although the taxpayer may offer proof to the contrary. No court action to prevent the assessment or collection of any tax may be maintained, but the taxpayer may appeal to the Collector of Internal Revenue by a claim (Form 47) for the abatement of any assessment made by the Collector. The filing of a bona fide claim for abatement prevents the imposition of the 5% penalty, but interest on the unpaid amount runs at ½% per month from the original due date. Any amount not believed to be due should be paid under protest, that is a written protest should be delivered with the payment, stating that the tax is paid under duress and not voluntarily and denying the legality of the assessment and collection, and a receipt marked "Paid Under Protest" should be requested.

Any amount paid contrary to law may be recovered by a claim for refund (Form 46). A suit to recover taxes paid can also be brought against the United States or the collector, but only after a claim for refund has been duly filed and within two years after such claim for refund has been rejected or has been on file for six months without decision. Claims for refund must be filed within two years from the date payment was made, or within five years if the overpayment appears from the face of the Return. Amounts found to be due may be applied against similar taxes due by the same taxpayer for a different period.

PART 5. INFORMATION AND PAYMENT AT SOURCE.

193. **Returns of Information.** Every person, partnership, and corporation is required to file Returns of Information at the Source, subject to penalties similar to those imposed for delinquency in filing the Income Tax and Profits Tax Returns. The Returns of Information must be made on the calendar year basis and not for the fiscal year, and are filed at Washington by mail, not with the local collector.

194. **Payments of $1,000 per year.** At the time fixed by the Regulations in each year, without further notice or demand, there is due a Return (Form 1096) showing the amount of all payments made during the year of fixed and determinable gains, profits and income (such as salaries, interest, or rent), amounting to $1,000 or more for the year, and a separate report (Form 1099) showing the name and address of each recipient. The requirement is not limited to periodical payments, but a single payment of $1,500 as fees to a lawyer or commissions to a broker would be included. Payments which are not purely income to the recipient, for example payment for merchandise, storage, or telephone service, are not included.

195. **Corporation Interest and Dividends.** Upon notice from the Treasury Department, a corporation may be required to file the Return of Information as to the interest paid upon its bonds or similar obligations, without regard to the amount of the particular payments. (See par. 199 as to Returns for interest on tax-free bonds.) A similar Return as to dividends paid must be filed, but only after notice from the Treasury Department.

196. **Brokers.** Brokers may be required to make Returns showing the names of all customers, details as to the profits and losses of each, and such other information as the Regulations may require.

197. **Foreign Interest and Dividends.** A Return may be required of every person in the business of collecting coupons, checks, or bills of exchange not payable in the United States, in payment of interest on bonds of foreign countries and foreign corporations, or dividends on stock of foreign corporations, and all such payments, no matter how small the amount, must then be reported. If such interest or dividends are payable in this country by a resident fiscal agent the requirment does not apply. Persons undertaking the collection of such foreign items as a matter of business or profit must be licensed by the Treasury Department.

198. **Payment at the Source.** In order to assist in the collection of the tax, payment is required by the person paying the income, rather than the one receiving it, in the case of interest on tax free bonds and payments to nonresident aliens (see par. 20) and foreign corporations (see par. 37) of fixed and determinable annual or periodical income (but not including interest on tax free bonds or dividends of domestic corporations) without regard to the amount of the payment. On or before March 1 of each calendar year, with no provision for fiscal years, persons making the specified payments must make Returns and by June 15 must pay the tax to the government. The law permits the amount so paid to be deducted and withheld from the payment made to the recipient, except where there is a contractual obligation to the contrary, as with tax free bonds.

199. **Interest on Tax Free Bonds.** Whenever bonds, mortgages, or similar obligations of a corporation contain a contract or provision by which the corporation agrees to pay the interest upon such obligation without deduction for any tax which the corporation may be required or permitted to pay thereon or to retain therefrom under the Federal Income Tax Law, or by which the corporation agrees to pay, on behalf of the owner of the bonds, any portion of any federal income tax imposed upon the interest, or to reimburse the owner therefor, the corporation is required to pay to the government a tax of 2 per cent of the interest. As there are many different forms of "tax free covenants," it must be determined in each case whether the language used covers the federal income tax. These provisions apply only to long term or funded obligations which may be classed as securities, and not to promissory notes, scrip, or ordinary commercial paper. Securities issued by syndicates, partnerships, or individuals, subject to tax free covenants, are not included although they may in all other respects resemble the obligations of corporations, as to which payment at the source is required. The tax must be paid without regard to the amount of the particular payments, but only when the interest is paid to an individual (or foreign corporation) and not when paid to a partnership or domestic corporation. The tax need not be paid if the owner files a notice before February 1 claiming exemption or credits covering the interest received during the previous year. This claim (Form 1001) is usually filed at the time the interest is collected. Where ownership is not known, the tax should be paid.

200. **Certificates of Ownership.** Any person making payments of income for which he is required to pay a tax at the source or to give information at the source is entitled to demand the necessary information from the recipient of the income, and certificates in appropriate form may be secured for this purpose from the collector.

PART 6. ILLUSTRATIVE CASES

1. Individual Income Tax.

201. **Dry Goods Store.** Abel Wise conducted a dry goods store. In December 1917, he inventoried his stock in trade at $21,000, which was

the cost. During 1918 he purchased $63,000 worth of goods and sold a total of $81,000 in retail trade. In December, 1918, his goods inventoried $27,000 at cost price and would be more at market value, although he had no more on hand than at the time of the previous inventory. During the year his family has used $247 worth of goods taken from the stock. **Answer:** (See paragraphs 78, 79, 133, 139, 140). Abel Wise will add the inventory of the stock on hand at the first of the year to the purchases, making $84,000, and will deduct the inventory taken in December, 1918, giving a net cost of $57,000. This amount deducted from the sales of $81,000 leaves $24,000 as gross income. The value of the goods consumed must be added. In addition, Wise will deduct from this his general expenses, losses, depreciation, etc., to determine his net income.

202. **Landlord.** Christopher Hansen owned an apartment house containing three apartments, all of which were heated by one furnace in the basement. Hansen lived in the first floor apartment with his family and rented the two upper apartments for $45 a month each, furnishing the heat, light for the halls, running water, and a janitor. How should the apartment figure in Hansen's income schedule? **Answer:** (see pars. 79, 127, 133, 144, 174)—Hansen must determine how much of the cost of the heat, light, running water and janitor service is attributable to his own apartment, and the balance of such cost he may deduct from his gross income as expense. The same proportion of the depreciation of the building should also be deducted. The entire amount received as rent, but not the rental value of his own apartment, must be included in the gross income.

203. **Professional Income.** George Lee is a physician supporting a family consisting of his wife, two children under age and two over eighteen years of age. He owns an automobile which he uses both in his professional work and for pleasure, fully three-fourths of its use being for business. During 1918 the cost of running the automobile included the salary of his chauffeur, $1,456; gasoline, repairs, and other expense, $1,638.25; insurance $53.85. The depreciation of the automobile is estimated at $150, one-tenth of its original cost. During the year the doctor spent $437 for club and lodge dues, entertainment, etc., which he charges to an account called "good will promotion." To the same account he charges $200 which he donated to the local charity organization and $17 which were his expenses on a short trip to give a free lecture for a local Y. M. C. A. He spent $460 during the year attending medical conventions, $36 for medical journals and dues for medical societies, and $300 for books and instruments of a permanent value. His office and traveling expenses were $14,948.40 for the year. His professional fees amounted to $30,653 for the year and in addition he received $419.30 as compensation for a short period which he served in the army before the armistice. He spent $600 for uniforms, equipment, etc., when in the army. Doctor Lee also owned a house which he rented during the year for $1,356. The expenses for repairs, insurance, etc., on this house were $16.06 and the depreciation is estimated at $200. The taxes upon this rented property and upon the home of Doctor Lee amounted to $509.19. The Doctor's wife received $95, as interest on a

mortgage. How will Doctor Lee report his net income? **Answer:** (See pars. 78, 133, 143, 144, 158, 182)—The gross income from services will include the professional fees amounting to $30,653, but not the compensation received in the army. From this will be deducted the office and traveling expenses, three-fourths of the automobile expense and depreciation, expenses of attending conventions and cost of medical journals and societies, a total of $17,917.97, making his net income from services $12,735.03. The club dues, etc. and the cost of army equipment are personal expenses. The cost of books and implements is not deductible, but the Doctor should carry a property account and charge off a depreciation and obsolescence allowance upon such property. The net income from the rented property is $1,139.94. The interest on Mrs. Lee's mortgage will be included on the Doctor's Return. The taxes will be deducted, as will the $200 charitable donation. The $17 is not deductible because it was an expense and not a donation, although incurred in a charitable enterprise. The total net income was therefore $13,180.78, which will be taxed as follows: Deduct wife's income, leaving $13,085.78, upon which the normal tax, deducting the $2,400 exemption, is $1,042.29, the surtax is $244.29, and the total tax is $1,286.58. Adding the $5.70 normal tax on the income of Mrs Lee, the total tax shown by the Return is $1,292.28.

204. **Farmer.** Henry Woodhouse, a farmer, had the following transactions among others during 1918: In the month of May he purchased for $400 a breeding sow with a litter of five young pigs. He sold the five pigs in December for a total sum of $200 cash and kept the sow. He also bought some cattle for feeding and resale, which be still had on December 31. How must he figure these items in his Return? **Answer:** (See paragraphs 94, 142). Woodhouse must determine the cost of the sow as apart from the pigs at the time of purchase. The cost of the sow must be included in the permanent investment account and not as a deduction from gross income. The profit on the pigs must be included in the gross income. The expense of keeping and feeding the pigs may be added to the original cost in determining profit, or they may be omitted here, and included as part of the general expense of the farm on the Income Tax Return. The cost of the cattle is not deductible, but when they are sold the profit or loss will be then determined.

205. **Inadequate Accounts.** Walter Bower, supporting a wife and mother, is in the brick manufacturing business. His bookkeeping system is very crude, and he estimates his profits by the annual increase in his bank balance and investments. On January 1, 1918, he estimated that his plant was worth $16,000, with brick on hand worth $5,000. He had $1,000 in the bank, and $4,000 drawing interest at 7% in a building and loan association. On December 31, 1918, his plant had depreciated somewhat in value; his brick on hand was worth $3,500; his bank balance was $1,000; his building and loan association deposits were $6,000; he had a touring automobile purchased for $800 in May of the same year. He estimated his personal and home expenses at $200 a month. How shall he determine his income tax? **Answer:** (See paragraphs 59, 85, 101, 141, 175). Since Bower has not kept an account, his income must be estimated. He has spent during the year, $2,400 for living expenses, $800 for the

automobile, and $2,000 added to his building and loan investment, or $5,200, which he must have received. On the other hand, his stock of brick is reduced $1,500, so that, as his bank balance is the same, his gross income was probably $3,700, and should be so returned. He is entitled to deduct from this gross income the depreciation of his brick plant, which would be, at 3%, $480, leaving his net income $3,220. Deducting his exemption of $2,000 (his mother being neither mentally nor physically defective) he must pay 6% on $1,220, or $73.20.

206. **Securities.** Elam Stratford, retired, living with his wife, has an income of $8,000 a year, derived as follows: $1,000 from Pennsylvania Railroad Stock, $1,000 from Middle East Utilities Corporation 6% gold bonds (guaranteed tax free), $800 from Anglo-American Steamship Company bonds (not tax free), $200 from Yucatan Gum Corporation stock (a Mexican corporation doing no business in the United States and not subject to the Income Tax Laws), $2,000 from a stock farm which is under the management of a foreman, and $3,000 a year from a partnership engaged in the leather business, from which he retired, but in which he retains a direct interest. How must he figure his income tax? **Answer:** (See paragraphs 94, 114, 116, 135, 142, 199). Mr. Stratford's Return would be as follows: from business, etc., $2,000 (from the stock farm); partnership profit, $3,000; interest on tax free bonds, $1,000; other interest $800; dividends from foreign corporations, subject to normal tax, $200 (from the gum corporation); dividends from domestic corporations, $1,000 (from the Pennsylvania Railroad stock). The totals will be: Gross Income and Net Income, $8,000; dividends, $1,000; exemption $2,000, and income subject to normal tax, $5,000. Normal tax, $360; credit amount of normal tax paid at source, $20; balance of normal tax due, $340, surtax on $8,000, $50. Total Income Tax, $390.

207. **Exempt Income.** Howard Johnson, unmarried, has an income of $60.00 a month as a law clerk. He owns United States Steel Stock, netting him an income of $500 a year. On May 1, 1918, he received $10,000 as a legacy from his mother's estate, all of which he invested in United States Liberty Bonds, netting him 3½% interest, payable semi-annually, June 15 and December 15. How shall Johnson make his return for the year 1918? **Answer:** (See pars. 63, 72, 78, 116). The gift from his mother's estate is not taxable and need not appear anywhere in his Income Tax Return. His gross income includes salary $720, and dividends $500, total $1,200, so he must file a Return. The interest on the Liberty Bonds is not shown on the Return and the dividends are exempt from the Normal Tax. The personal exemption of $1,000 leaves no taxable income.

2. Corporation Income and Profits Tax.

208. **Return for Part of Year.** The Kramer Crane Company has always made its Income Tax Returns on the calendar year basis, but its books are kept on the basis of a fiscal year ending on Februry 28. How should it make its Return for 1918? **Answer:** (See pars. 29, 58). The Return which it must file on or before March 15, 1919, will cover only the two months of January and February, 1918, and will show

the actual income of those two months, the invested capital at that time, including surplus earned prior to January 1, 1918. The Profits Tax and Income Tax credits will be reduced to 1/6 of the specific exemptions, 1/6 of the prewar income, and 1/6 of the allowance of 8% of the invested capital. On or before May 15, 1919, it must file Returns covering the twelve months ending on February 28, 1919. Upon this Return the tax will be the sum of (a) five-sixths of the tax computed at the 1918 rates and (b) one-sixth of the tax computed at the 1919 rates, using the entire net income and entire credits for both computations.

209. **Loss on Property Discarded.** The Lenaire Company erected a brick factory building in January, 1915, at a cost of $10,000, and installed equipment and machinery costing $5,000. In making its Returns of income for the years 1915, 1916, and 1917, the company made no deduction for the depreciation of the building, but deducted 5% of the cost of the machinery as depreciation in the 1917 Return. In January, 1918, the company erected a new and enlarged plant upon the same site, selling the materials in the old building to a wrecking company for $800. Improvements in processes and machinery made it advisable to dispose of all the old equipment, which was sold for $1,500, and entirely new equipment was installed. How will this affect the income for 1918? **Answer:** (See pars. 122, 172, 175, 176). The cost of the old building may be carried as one item in the cost of the new building or it may be charged off. The building has depreciated probably at the rate of 2% each year, or a total of $600. The actual loss, above the salvage, is therefore $8,600, which may be deducted from the 1918 income as a loss. The machinery has probably depreciated 10% to 15% in each year. Taking the 15% figure as the fact, there has been an actual depreciation of $2,250 (of which only $250 has been charged in the books), leaving the residual value over the salvage, $1,250, which may be deducted as a loss in 1918. The depreciation used to determine the residual value should be charged upon the books of the company, and the company should ask leave to file amended Returns for the years 1915, 1916, and 1917, claiming the benefit of such depreciation which was not claimed at the time. If the amended returns are accepted they should be accompanied by a claim, on Form 46, for refund of the tax paid on income in excess of the actual income.

210. **Timber Company.** The Western Timber Corporation purchased standing timber in the year 1910 which on March 1, 1913, had a well established market value as follows: Oak, $9 per thousand feet; pine, $8 per thousand feet, and mixed timber, $6 per thousand feet. The corporation owned its own saw mill and in 1918 cut and sold one million feet of lumber of each of the above grades. How shall the corporation make out its Return. **Answer:** (See par. 179.) The value on March 1, 1913, of the timber sold will be deducted by a depletion allowance; the expenses of manufacturing and selling are to be deducted in the general deduction for expense.

211. **Reorganization.** The P. & A. Corporation had been unable to pay any dividends to its stockholders for several years and in 1917 failed to earn the interest on its bonds. The following scheme of reor-

ganization was proposed by a bondholders' committee and was adopted by the consent of all parties. The company had outstanding stock amounting to $500,000, par value, $100 a share; first mortgage bonds amounting to $300,000 in denominations of $1,000 each, and second lien debentures amounting to $200,000, also denominations of $1,000. The plan was to exchange all of the outstanding stock and bonds for a new issue of stock in the same amount as formerly, and to sell new bonds for cash to be used in restoring the business. The first mortgage bonds were exchangeable for an equal amount in par value of the new stock, the debentures for one-half of their par value, and the old stock for one-fifth of its par value, of five shares for one new one. All of the securities were exchanged on this basis. Walter Harmon owned ten of the bonds for which he received 100 shares of the new stock, ten of the debentures for which he received 50 shares, and 500 shares of the old stock for which he received 100 shares of the new stock. He also bought ten of the new bonds at 96. How shall the transaction be reported in the income tax Returns of Harmon, and of the P. & A. Corporation? **Answer:** (See pars. 110, 131, 169). As to Harmon, the transaction may be considered as closed and the par value of the securities taken as the basis of profit and loss. As to the first mortgage bonds there is no loss unless Harmon bought them at a premium; if the price he paid for them, or their value on March 1, 1913, was anything less than par, he need not report a profit on his return but may hold the new stock at the same cost. On the debentures there has been a loss of $5,000 as a debt ascertained to be worthless. On the shares of stock there has been a profit or loss equal to the difference between $20 per share and the value as of March 1, 1913, or, if purchased since that date, the cost. The bonds purchased at 96 are an investment upon which there is no profit or loss until they are sold or paid off. The corporation has been relieved of $500,000 of indebtedness, but this is not income. The debt was in part paid by giving each creditor a shareholder's interest in the assets of the corporation; the balance was, if anything, a gift. Neither the cancellation of some of its capital stock liability nor the creation of other capital stock was gain or loss to the corporation. The issue of the bonds at 96 involved a loss of 4% of the amount issued, to be pro-rated and deducted in annual installments during the life of the bonds.

212. **Corporation Promotion.** The Hamilton Equipment Corporation was organized in January, 1918, to exploit a newly patented device for making iron castings. The company was capitalized at $100,000. In order to make the stock fully paid and non-assessable, and at the same time available for sale at less than par without a stock liability, an arrangement was made with the patent owner whereby his device was assigned to the company for all of the stock of the corporation and whereby the inventor turned back into the treasury of the company 49% of the stock as "treasury stock," to be sold for the benefit of the company in creating working capital. How must this transaction be scheduled in the Return? **Answer:** (See pars. 43, 47, 63, 108, 109). The stock is a gift to the corporation, and therefore neither its value nor the proceeds upon its sale need be included in the Income Return. If there

is an increase in its value, so that it is sold for more than its value when received, such increase should be accounted for as profit. The invested capital will be the amount actually realized by the sale of the treasury stock plus an amount not in excess of (a) the actual value of the patent when acquired or (b) 25% of the stock outstanding at the first of the year, not including treasury stock, or (c) $51,000, the par value of the stock issued for the patent.

213. **Buying Leasehold.** The Fidelity Shoe Stores issued $50,000 of its capital stock to pay for a leasehold having twenty-five years to run. How shall this be scheduled in the Returns? **Answer:** (See pars. 48, 109, 144). 4% of the actual value of the stock when issued may be charged off the books each year as an expense of doing business. The leasehold is tangible property which may be included in the invested capital at its actual value when acquired.

214. **Invested Capital of Consolidation.** In 1901, the Stewart Shirt Company was organized and took over the assets of a dozen going concerns, issuing therefor $250,000 of capital stock. The assets consisted of various plant structures, equipment, real estate, patents, and good will. At the time of the transaction all of these items were entered in a lump sum and no attempt was made to indicate the specific amounts of stock issued for the respective kinds of property. It is shown that at that time the tangible property was worth $100,000, the patents $20,000, and the good will not less than $70,000. How is the invested capital to be computed? **Answer:** (See pars. 47, 49). It will be presumed that $100,000 of the stock was issued for the tangible property, and that $150,000 was issued for the good will, which can be included only at not more than 25% of the outstanding capital stock, or $62,500. The invested capital will therefore be $162,500, plus any undivided profits.

215. **Comparative Profits Tax.** For very many years the Marc & Wright Co. conducted a cannery which had been very profitable and which had been several times enlarged. The company had kept very inadequate books and had no record of the cost of the plant and equipment. The net income for the year 1918 is $52,000, and the Return claims the benefit of the assessment at the comparative rate. The Commissioner of Internal Revenue determines that the average Profits Tax of representative corporations, in the cannery business, under similar circumstances, is 41% of the net income. The Commissioner finds that he is unable to determine the invested capital. How will the Profits Tax be computed? **Answer:** (See pars. 27-28). The Return will show a Profits Tax of 50% of the net income, or $26,000, and an Income Tax of $3,120. The Marc & Wright Co. will pay the first installment of $7,280, and subsequent installments which come due before the decision on the claim. The Commissioner, through the collector, will notify the company of his decision and of the assessment of the Profits Tax at 41% of the net income, or $21,320. The Income Tax is $3,681.60 in addition. Since each installment is reduced by $1,029.60, this amount of each payment will be credited toward any installments remaining unpaid or will be refunded.

216. **Losses and Invested Capital.** The Greenhill Ice Company was incorporated for $70,000, all of which was paid in with cash and invested

in a plant for making ice, which was built by the company in 1914. The books of the company made no allowance for depreciation and showed an accumulated loss from operations of $15,000 on January 1, 1917. During 1917 it earned $16,000. What is the invested capital for 1918? **Answer:** (See pars. 44, 46, 50). The amount of the loss and also the amount of depreciation actually sustained, probably 2% per year on cost of building and 10% per year on cost of machinery, must be deducted from any undivided profits which are to be included in the invested capital, and therefore the $16,000 earned in 1917 may not be included. The losses need not be deducted from the $70,000 capital, since the stockholders have never received any part of their original investment and have full credit for the $70,000 which they still have in the business.

217. **Appreciation and Invested Capital.** The real estate which was purchased by the Greenhill Ice Company for $15,000 has more than doubled in value, according to an appraisal made in 1916, and it is carried on the books at $30,000, the $15,000 of increased value having been added to offset the accumulated losses of $15,000. How will this affect the invested capital? **Answer:** (See pars. 44, 46, 50). Invested capital must not include any part of the increased valuation, but $15,000 must be deducted from the book value of assets, and from any book surplus (but not from the original investment).

TITLE 2. CAPITAL STOCK TAX.

218. **Nature and Application.** A special excise tax known as the Capital Stock Tax is levied upon carrying on or doing business in the corporate form within the United States. The tax is paid in advance for the government's fiscal year, that is, from July 1 to June 30, but it is measured by the fair value of the capital stock during the year preceding that for which the tax is paid. The tax is at the rate of $1 for each $1,000 of such value above the exemption of $5,000. This rate applies for the first time for the period beginning July 1, 1918, and will be assessed upon the Return made during 1918 under the previous law, although such Return shows a higher exemption and a lower tax rate. The tax applies to every corporation, joint stock company or association, mutual insurance company, limited partnership, "Massachusetts Trust," or other association of participating or shareholding members, except that corporations which are exempt from Income Tax (par. 33) are likewise exempt from this tax.

219. **Corporations Formed or Dissolved During the Year.** The law expressly provides that the tax shall not be imposed upon any corporation which was not engaged in business during the preceding taxable year. Therefore, a corporation organized or first engaging in business after July 1, 1918, is not subject to any tax for the fiscal year 1918-1919, even though it exercises the corporate privilege during that year. A corporation which was doing business during the preceding year for even one day is subject to tax. It is held that any corporation which succeeds another corporation pursuant to

an agreement, is subject to the tax. On the other hand the tax is imposed only upon corporations which carry on business during the taxable year, so that a corporation dissolved on or before June 30, 1919, is not subject to the tax for the fiscal year 1919-20. If a corporation is dissolved ten days after the beginning of the taxable year, it must make a Return and pay the full rate of tax without any refund because of the dissolution.

220. **Inactive Corporations.** Since the tax is imposed only upon "carrying on or doing business," a corporation may be exempt because it was not engaged in business during the taxable year or the preceding year, even though it may have been in existence during both years. The following are typical cases of corporations not subject to tax for this reason: (1) A corporation in the hands of a receiver and not doing business as a corporation; (2) a corporation in the process of dissolution and liquidation at the beginning of the taxable year; (3) a corporation which has entirely abandoned its business; (4) a holding company, which performs no activities other than the ownership of stock of subsidiaries, the collection of income therefrom, and the distribution of such income in dividends; (5) a corporation which merely holds title to property subject to a long term lease or otherwise out of its control, and which receives the income from such property and distributes the same as dividends.

221. **The Return.** Every corporation must make a Return to be filed in July of each year, subject to penalties similar to those explained in connection with the Income Tax Return.

222. **Determination of Fair Value.** The tax is based upon the fair average value of the capital stock for the preceding year ending June 30. This value is an entirely different matter from the par value of the stock or the amount of the invested capital. It is to be estimated by the officers of the corporation, their estimate being supported by a showing of the book value, the market value, and the earning value, which appears on the Return in three statements designated as Exhibits A, B, and C. Every corporation must fill out all of these exhibits or state why the required data is not available. The fair value upon which the tax is based will be that reflected by the exhibit showing the greatest value, except that the corporation may submit a statement showing why the tax should be assessed on some other basis.

223. **Book Value Determined by Exhibit A.** Exhibit A is a condensed balance sheet as of the end of the fiscal year of the corporation, showing all assets and liabilities according to the books of the company, and also at the fair actual value wherever this differs from the book value. The difference between the fair value and the books of the company must be explained in sufficient detail to enable the Commissioner of Internal Revenue to determine if the adjustments are proper and acceptable. The books of the company need not be adjusted to take up the differences shown. The capital, surplus, and undivided profits, as shown by the balance sheet, is, of course, the book value of the capital stock, and since opportunity is given for adjustment, will represent the judg-

ment of the officers as to the actual value. No provision seems to be made on the Return for finding the average of such book value for the year, which is the required value according to the law.

224. **Market Value Determined Under Exhibit B.** Exhibit B represents the market price of the stock. If the stock is listed Exhibit B should show the mean of the highest and lowest bid price for each month and the average of these figures will be the average for the year. The taxpayer may attach a schedule showing the highest and lowest bid price for each day rather than for each month. If the stock is not listed, Exhibit B should show the prices obtained upon any sales made, when such prices are known to or determinable by the officers making the Return. In reporting such sales, a statement must be attached showing the number of shares involved and the existing conditions. Sales under special conditions influencing prices will not be considered representative of fair value and should not be given on the Return.

225. **Earning Value Determined Under Exhibit C.** Exhibit C shows the value of the stock determined by capitalizing the earning capacity. The Exhibit shows the income for the preceding five years as reported for the Income Tax and such deductions and additions as are fairly required to obtain the actual income realized by the company. A comprehensive analysis of any amounts reported as deductions or additions should be attached to the Return. The Return does not suggest the rate to be used in capitalizing the average income, but states that the officers making the Return will use "such percentage as from their special familiarity with the business they know representative enterprises in their line in their locality must earn in order to maintain their stock at par." Thus, if an 18% return is necessary to hold the value of the stock at par, this Exhibit will estimate the fair value by showing 100/18 of the average earnings. If the company has actually earned 27% on the capital stock, the capitalized value will be $150 per share.

TITLE III. MISCELLANEOUS WAR TAXES

1. Transportation and Communication.

226. **In effect** April 1, 1919.

227. **Rates.** Based on amount paid for service. Freight, 3%. Express, 1 cent on each 20 cents or fraction. Passengers, 8% (except fares not over 42 cents and commutation or season tickets for trips of less than 30 miles). Seats, berths, staterooms, 8%. Oil by pipe line, 8%. Telegraph, telephone cable, or radio dispatch, message, or conversation, (a) 5 cents if charge is 15 cents to 50 cents, (b) 10 cents if charge is more than 50 cents. Leased wire or talking circuit special service (except for public press or common carrier), 10%. Services for federal or state governments exempt. Transportation includes incidental services, storage, demurrage, etc. Not limited to common carriers.

2. Insurance.

In effect April 1, 1919.

228. **Rates.** Life insurance—(1) industrial plan policies, not over $500 (may cover in addition health and accident insurance), 20% of first monthly premium, or 40% of first weekly premium; (2) other policies, 8 cents per each $100 or fraction of face of policy; (3) group life insurance, not less than 25 lives of person with single employer, for benefit of persons other than employer, 4 cents per $100 of aggregate face amount. Marine, inland, and fire insurance, 1 cent on each $1 or fraction of premium. All other insurance for loss, damage, or liability (excluding guaranty and fidelity insurance, but including health, accident, burglary, employers' liability, and casualty insurance)—(1) industrial plan policies, 20% of first monthly or 40% of first weekly premium; (2) other policies, 1 cent per $1 or fraction of premium.

3. Excise Taxes.

229. **In effect:** (1) Tax on sales at wholesale, day after the President signs the Act. (2) Tax on sales at retail—perfumes, etc., May 1, 1919; jewelry, etc., April 1, 1919; sculpture, etc., day after President signs the Act.

230. **Apply:** (1) **Wholesale Sales.** On selling price received by manufacturer, producer or importer, except that tax is based upon customary wholesale price in the case of retail sale by a manufacturer, producer, or importer who customarily sells at both retail and wholesale. (2) **Retail Sales.** On price received by a dealer upon a sale to the consumer or user.

231. **Rates:** (1) **Wholesale Sales.** Automobile trucks and automobile wagons, 3%. Other automobiles and motorcycles, 5%. Automobile accessories (except when sold to automobile manufacturers), 5%. Pianos, organs (other than pipe organs) piano players, graphophones, phonographs, talking machines, music boxes and records therefor, 5%. Sporting goods and games (except childrens toys and games), 10%. Chewing Gum, 3%. Cameras, weighing not more than 100 pounds, 10%. Photographic films and plates (other than moving picture films), 5%. Candy, 5%. Fire arms, shells and cartridges (except those sold for the use of

certain governments), and hunting and bowie knives, 10%. Dirk knives, daggers, sword games, stiletto, and brass and metallic knuckles, 100%. Electric fans (portable, 5%). Thermos and thermostatic bottles or containers, 5%. Cigar or cigarette holders and pipes, composed wholly or in part of meerschaum or amber, humidors and smoking stands, 10%. Automatic slot-device vending machines, 5%, and weighing machines, 10%, sold or put into operation for profit by the manufacturer; liveries and livery boots and hats, hunting and shooting garments, and riding habits, 10%. Articles made of fur on the hide or pelt, or articles of which any such fur is the component material of chief value, 10%. Yachts and motor boats, not designed for trade, fishing or national defense, and pleasure boats and canoes if sold for more than $15, 10%. Toilet soaps and toilet soap powders, 3%. (2) **Retail Sales.** Jewelry, watches and clocks, opera glasses, etc. 5%. Perfumes and preparations for toilet purposes, and pills and proprietary medicines, 1 cent on each 25 cents or fraction (may be made payable by stamp). Sculpture, paintings, art porcelains and bronzes sold by any person other than the artist, 10% (except upon sales to public art museums or educational institutions). (3) **Luxury Taxes.** A tax of 10% on the amount by which the retail price of certain specified articles, chiefly wearing apparel, exceeds the price stated in the law. Not given here because of announcements that these taxes will be repealed before they become effective on May 1, 1919.

4. Admissions.

232. **Tax:** 1 cent for each 10 cents or fraction paid for admission to any place (except cabarets). Payable by person paying for admission.

233. **Carbarets.** If admission charge is wholly or in part included in price paid for refreshment, service, or merchandise, 20% of amount paid will be deemed to be the admission charge, and will be taxed 1½ cent on each 10 cents or fraction. Effective April 1, 1919.

234. **Tickets Sold at Advanced Price.** (1) By proprietors or employees, 50% of regular or established price. (2) By other persons, at places other than ticket office (a) 5% of excess if not more than 50 cents, (b) 50% of excess if more than 50 cents. $100 fine for selling ticket not conspicuously and indelibly marked with price for which sold and name of vendor if not sold at ticket office. Effective April 1, 1919.

235. **Exemptions.** Admission without charge of (a) persons in military or naval forces of the United States when in uniform, (b) children under twelve years of age, (c) municipal officers on official business, (d) employees. Where proceeds inure exclusively to the benefit of (a) persons in military or naval forces of the United States (b) religious, educational or charitable institution, societies or organizations, (c) societies for the prevention of cruelty to children or animals, (d) symphony orchestra organizations, and agricultural fairs, none of the profits of which are distributed to members.

5. Dues.

In effect April 1, 1919.

236. **Tax.** 10% of dues or membership fees, where dues of an active resident annual member are in excess of $10.00 per year. 10%

on initiation fees where either such fees or annual dues exceed $10.00. Life members pay annually the tax upon the annual dues paid by other members, but the fee for the life membership is not taxed.

237. **Applies** only to dues or fees of social, athletic, or sporting club or organization, not including fraternal societies operating under the lodge system.

6. Federal Estate Tax.

238. **Application.** To the transfer of property at death. Based upon entire taxable estate, without regard to the amount of the distributive shares or relationship of the beneficiaries. Whole estate of decedents who were residents of the United States; nonresident decedent's estate situated in this country. Executor, including any person taking possession of the decedent's property, must make a Return if the gross estate is over $50,000.

239. **Rates:** The "1917 Rates" apply to estates of persons dying after October 3, 1917, and before the passage of the 1919 law. The "1919 Rates" apply to estates of persons dying after the day the President signs the new law:

Taxable Estate		*1917 Rates*	*1919 Rates*
$50,000 is exempt.			
Next	$ 50,000	2%	1%
"	100,000	4%	2%
"	100,000	6%	3%
"	200,000	8%	4%
"	300,000	10%	6%
"	250,000	10%	8%
"	500,000	12%	10%
"	500,000	12%	12%
"	1,000,000	14%	14%
"	1,000,000	16%	16%
"	1,000,000	18%	18%
"	3,000,000	20%	20%
"	2,000,000	22%	22%
Exceeding	10,050,000	25%	25%

240. **Exemptions.** Estate of person dying while serving in military or naval forces of the United States in the present war, or from injuries received or disease contracted while in such service. Property identified as a share in the estate of another person who died within the preceding five years and whose estate was subject to the federal estate tax. Gifts to the United States, a state, or a local government for public purposes, to charitable corporations, or to trustees for charitable purposes (effective December 31, 1917). Funeral expenses, administration expenses, claims, losses, support of dependents during settlement. Property held in life interest.

241. **Taxable Estate.** Includes value, at time of death, of: decedent's interest in property subject to charges against estate; dower, curtesy, or similar interest of surviving spouse; property transferred in contemplation of death, presumptively including any material part of decedent's property disposed of without money consideration within two years prior to death; entire amount of property jointly held with

another except as proof is made of the interest of other owners; property passing by general power of appointment, by will or in contemplation of death; insurance on policies taken out by decedent upon his own life, payable to his estate and the excess over $40,000 payable to other beneficiaries.

7. Special Taxes.

242. The following annual excise taxes are levied upon the carrying on of certain kinds of business. Returns must be made by July 1, of each year, or upon commencing business. Effective January 1, 1919, except as noted.

243. **Rates.** Brokers of securities, produce, and merchandise $50. Brokers belonging to exchanges, additional tax, where value of membership is more than $2,000 but less than $5,000, $100—more than $5,000, $150. Pawnbrokers $100. Ship brokers and custom house brokers $50. Theatres, museums and concert halls: seating capacity not over 250, $50—seating capacity between 250 and 500, $100—between 500 and 800, $150—over 800, $200—in cities, towns or villages of population of 5,000 or less, one half of above rates. Circuses, $100. Other exhibitions, $15; street fairs, maximum, $100. Bowling alleys and billiard rooms, for each alley or table $10. Shooting galleries $20. Riding academies $100; Sight-seeing automobiles seating from three to seven, each $10—seating more than seven, each $20. Brewers, distillers, liquor dealers, and manufacturers of stills, carrying on business contrary to law $1,000. Use of pleasure boats taxed at double former rates, effective 60 days after passage.

8. Soft Drinks.

244. A new tax, effective May 1, 1919, is imposed upon the sale of soft drinks, ice cream, and similar food or drink served for consumption at the place of sale. The tax is 1 cent for each 10 cents or fraction paid, and is payable by the purchaser.

9. Child Labor Tax.

245. A new tax is imposed to discourage the employment of child labor, amounting to 10% of the net proceeds received or accrued during the taxable year from the sale of the product of (a) any mine or quarry in which children under the age of 16 years have been employed or permitted to work during any portion of the year, or (b) of any other manufacturing establishment employing children under 14 years or permitting children between 14 and 16 to work more than 8 hours in any day, or more than 6 days in any week, or after 7 P. M. or before 6 A. M., during any portion of the year. The tax applies to such employment after sixty days after the passage of the Act.

10. Leasing Motion Picture Films

246. In lieu of the former excise taxes, it is now provided that from May 1, 1919, any person engaged in the business of leasing positive motion picture films for exhibition shall pay a monthly excise tax equal to 5% of the total rentals for the preceding month. If a bona fide contract made prior to December 6, 1918, prevents the adding of the whole of the tax to the amount of the rental, then the lessor or licensee shall pay so much of the tax as is not added to the contract price.

11. Stamp Taxes.

247. Schedule. Tax.

Bonds of indebtedness, debentures, and certificates of indebtedness, issued by a person, partnership, or corporation, when issued or renewed, on each $100 of face value or fraction thereof	$0.05
All other bonds, including indemnity, surety, and penal bonds, policies of guaranty and fidelity insurance, and title guaranty and mortgage guaranty policies, but not including bonds required in legal proceedings,	
—on each $1.00 or fractional part thereof of premium charged	.01
—if no premium is charged	.50
Capital stock or certificates of interest in profits, of association or corporation when originally issued, in organization or reorganization—on each $100 of face value or fraction thereof of each certificate—if no face value on each $100 of actual value of fraction thereof of each share	.05
Sales or transfers of stock in association or corporation—on each $100 of face value or fraction thereof of each certificate—on each $100 of actual value or fraction thereof of each share without face value	.02
Sales of products and agreements to sell, on exchanges and boards of trade. for future delivery, for first $100 and for each additional $100 or fractional part thereof in value of the merchandise	.02
Drafts or checks, payable otherwise than at sight or on demand, and promissory notes, except bank notes issued for circulation, when issued or renewed, on each $100 or fractional part thereof	.02
Conveyance of real estate in case of sale, on each $500, or fraction thereof, of the consideration or value of the interest conveyed, (if more than $100)	.50
Entry of goods at custom house,	
—not exceeding $100 in value	.25
—exceeding $100 and not exceeding $500 in value	.50
—exceeding $500 in value	1.00
Entry for withdrawal of goods from customs bonded warehouse	.50
Passage ticket by vessel to a port or place not in the United States, Canada, or Mexico, sold or issued in the United States, for each passenger,	
—if cost exceeds $10 but does not exceed $30	1.00
—if cost exceeds $30 but does not exceed $60	3.00
—if cost exceeds $60	5.00
Proxy for voting at election or business meeting of a corporation (except religious, educational and other exempt corporations)	.10
Power of attorney (except to collect pensions, etc., and powers of attorney required in bankruptcy cases)	.25
Playing cards, not more than 54 in pack, per pack	.08
Parcel post packages, for first, 25c and each addition 25c or fraction thereof charged	.01

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